A combination of inflationary pressures, an abrupt commodity/energy shock and a change in central bank monetary policy have resulted in fixed income markets experiencing one of the largest corrections on record. Yet while increased levels of investor anxiety have been reflected in a broad market sell-off, we believe the negative technical landscape, with non-stop outflows in European high yield markets year to date combined with fast-rising real yields, have generated valuations that warrant a more constructive outlook for total return.

In our view, there are several reasons why investors should consider an allocation into European high yield.

**Valuations**

Credit spreads are trading wider than their long-term average (including prior to 2015 when quantitative easing was introduced in Europe). Combined with the rise in yields, the asset class is now showing an average price below 83 (as of 30 September 2022). With bonds redeemable at par, this offers investors the potential for what we believe to be significant capital gains.

**European High Yield - Timing your Entry Point**

October 2022

Despite a weakening macroeconomic backdrop, valuations in European high yield have reached what we believe to be interesting levels. Is now a good time to consider an allocation?

A combination of inflationary pressures, an abrupt commodity/energy shock and a change in central bank monetary policy have resulted in fixed income markets experiencing one of the largest corrections on record. Yet while increased levels of investor anxiety have been reflected in a broad market sell-off, we believe the negative technical landscape, with non-stop outflows in European high yield markets year to date combined with fast-rising real yields, have generated valuations that warrant a more constructive outlook for total return.

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**Fig. 1 European High Yield Spreads and Price**

Source: ICE Index Platform. Data as of September 30th, 2022. ICE BofA BB-B European Currency Non-Financial High Yield Constrained Index (HP4N). Muzinich views and opinion for illustrative purposes only, not to be construed as investment advice.

However, while yields are now significantly higher than they were at the start 2022, the number of distressed bonds with yields above 10% remains relatively small (Fig. 2), indicating the underlying fundamentals of the asset class remain relatively sound.

**Fig. 2 While Yields Have Risen, the % of Distressed Bonds Remain Low**

![Graph showing the percentage of distressed bonds](source: Moody's Europe Trailing 12-Month Issuer-Weighted Spec-Grade Default Rate Forecasts. Data as of August 31st, 2022. Muzinich views and opinion, not to be construed as investment advice.)

A weakening macroeconomic backdrop is likely to affect corporates. The market already appears to be pricing in this scenario, given the low average price in the European high yield market. As Fig. 3 highlights, the last twelve-month default rate is currently around 2%, having oscillated between 2-5% over the last decade. While there is likely to be a rise in defaults, we believe default rates should be relatively contained (unless the recession becomes severe) for several reasons:

1. **Historically, defaults have never reached levels currently being priced into the market**

   Based on the current level of the iTraxx Crossover at 655bps, the market is implying a cumulative default rate of 44% over the next 5 years, assuming a recovery rate of 40%. This isn’t a level we have seen before; even during the great financial crisis, defaults peaked at just over 9% and then fell in the following 3 years (Fig. 3).

**Fig. 3 Annual Default Rates**

![Graph showing annual default rates](source: Moody’s Europe Trailing 12-Month Issuer-Weighted Spec-Grade Default Rate Forecasts. Data as of August 31st, 2022. Most recent data available used. Muzinich views and opinion, not to be construed as investment advice.)
2. No Wall of Maturity

There are also a limited number of issuers needing to refinance over the next 12-24 months because of significant issuance in 2021. This provides us further comfort that we are unlikely to see a near-term unexpected spike in defaults. In addition, BB rated bonds constitute a high proportion of the index maturing in the next 1-2 years, which usually have better access to market financing.

Fig. 4 No Wall of Maturity

Source: ICE Index Platform. Data as of September 30th, 2022. ICE BofA Euro High Yield Constrained Index (HECO). For illustrative purposes only, not to be construed as investment advice.

Positioning a High Yield Portfolio for a Recessionary Environment

Clearly, risks remain, and the asset class is not immune from macroeconomic weakness in the months to come. As a result, we are pursuing a prudent strategy of under allocating to cyclical sectors such as retail and into more defensive areas such as healthcare, and telecoms.

Increasing exposure to higher quality credits with strong balance sheets while reducing exposure to smaller, less well-known issuers (which are less liquid and less supported by investors), Should also help provide protection during periods of elevated volatility. We shall continue, of course, to have a deep focus on fundamental credit analysis prior to investing, with a strong focus on capital preservation and downside protection.

This material is not intended to be relied upon as a forecast, research, or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The opinions expressed by Muzinich & Co are as of October 2022.

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Thomas is a Portfolio Manager at Muzinich and has 22 years of corporate credit experience. Prior to joining Muzinich, Thomas worked as an investment analyst at Trafalgar Asset Managers, a distressed-debt hedge fund. Prior to that, he worked as a financial analyst at GE Capital. Thomas has a Masters in Finance from London Business School, holds the Chartered Financial Analyst designation and has an M.Sc. in Corporate Finance from the Institut d’Etudes Politiques de Paris, France.
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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