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Rumble II: EUR vs. USD HY bonds: 1: nil

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We prefer EUR HY to USD HY given attractive hedged yield and spread pick-ups and we would rather be positioned in a lower beta market given the rally YTD, downside risks ahead and our base case for some spread widening by year-end in both markets. We caveat that our preference rests on our base case assumption for eurozone and global growth to be slowing but not recessionary in the next 12 months, as in such an environment, demand for yields and unattractive hedging costs for USD-assets should keep technicals relatively supportive for EUR vs. USD HY.

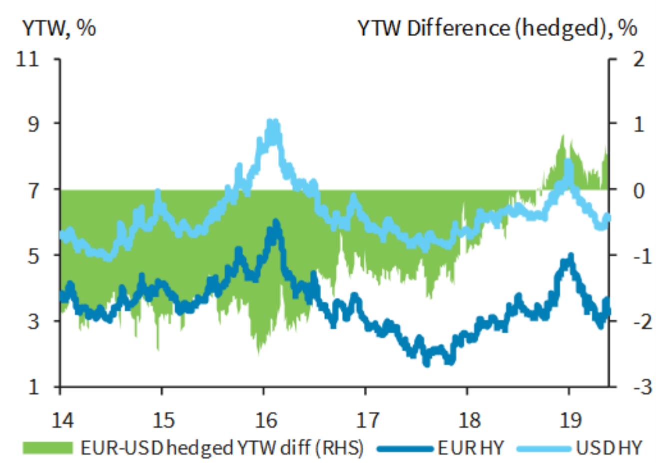
Contender profiles: EUR HY vs USD HY

On a hedged basis, EUR HY have looked more attractive than USD HY since the second half of last year (Figure 1 and Figure 2) and, despite recent compression, the average pick-up across rating buckets (BB to CCC) is still 1.2% on a hedged-yield basis and 120bp on a spread basis (Figure 10) for EUR HY vs USD HY. The headline index yield and spread pick-up for the EUR HY vs USD HY look lower (at +0.2% and +7bp respectively) due to the skew driven by the BBs-majority composition of the EUR HY index, while the USD HY index (Figure 5) has a much larger percentage (by c.20%) of single Bs and CCC bonds. [1]

The pick-up in hedged yield and spreads for EUR HY vs USD HY rose in the later part of last year for two reasons i) the rise in USD hedging cost and ii) underperformance of EUR HY vs USD HY spreads for most of 2018 except the fourth quarter.

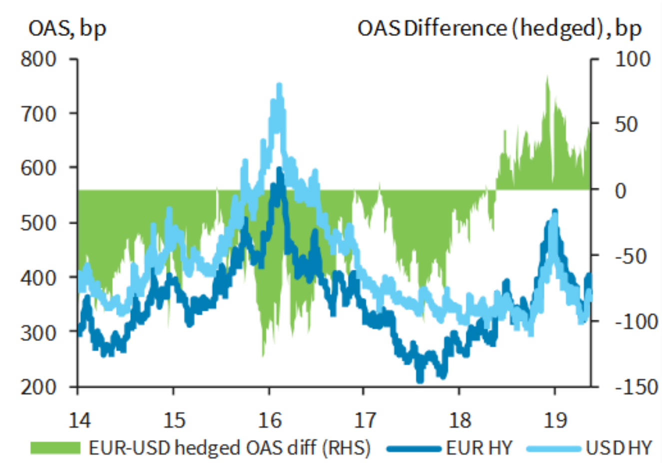
The rise in hedging costs isn't recent news: it began when the Fed started its hiking campaign in late 2015, which over time caused a divergence between USD and EUR Libors. This, coupled with a climb in cross-currency basis towards the end of 2017 and again at the start of 4Q 18, saw annualised 3m EURUSD hedging costs for non-USD investors rise from sub-1% at the close of 2015, to 2.2% at the end of 2017 and to a peak of 3.6% in mid-November last year, before gradually falling to 3.1% currently (Figure 3). For a full discussion on cross-currency hedge dynamics and estimating forward FX hedge costs, please see *Forward thinking*, 20 April 2018.

FIGURE 1
EUR vs. USD HY yield differential, hedged vs. unhedged



Source: Bloomberg Barclays Indices, Bloomberg, Barclays Research

FIGURE 2
EUR vs. USD HY spread differential, hedged vs. unhedged

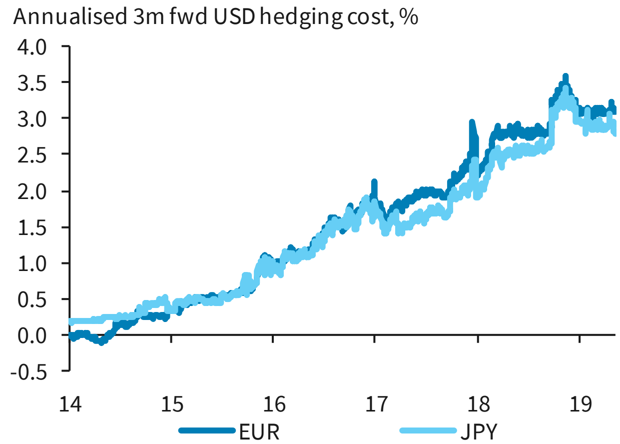


Source: Bloomberg Barclays Indices, Bloomberg, Barclays Research

[1] All references made to "EUR HY" or "USD HY" indices in this note refer specifically to the Bloomberg Barclays EUR (or USD) HY index ex-financials and hybrids but includes debt collectors.

FIGURE 3

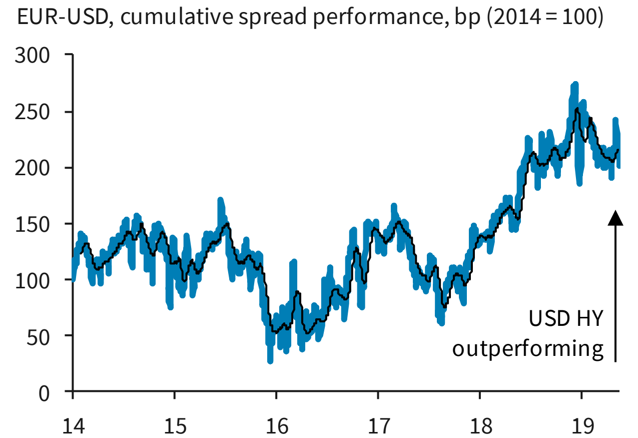
USD-EUR and –JPY hedging costs rose steadily over the latest Fed rate hiking cycle until the recent pause



Source: Bloomberg, Barclays Research

FIGURE 4

USD HY strongly outperformed EUR HY between 4Q '17 to the start of 4Q '18



Note: Trend line shows rolling 22 trading days' average.
Source: Bloomberg Barclays Indices, Barclays Research

Secondly, the EUR HY market also underperformed USD HY for much of 2018 (Figure 4), particularly in the first three quarters, driven by slowing Eurozone growth (vs strong US activity) and uncertainties caused by geopolitical risks such as Italy and Brexit weighing on sentiment and business confidence. The compression of spreads however did come to an abrupt end late in 4Q 18 as concerns on trade wars, external demand weakness, tighter financial conditions and a partial US government shutdown all weighed on market sentiment and the USD HY market saw large outflows (Figure 7).

EUR HY outperformed USD HY in 4Q 18, which was not surprising as Figure 6 shows EUR HY market excess returns are of a lower beta to the USD HY market historically. In part, this is explained by the higher quality composition of the EUR HY index, which also explains the historically low average trailing default rate in European vs US HY bond markets (averages since March 2000 are 4.7% and 1.2% for the US and European markets respectively; since 2014, the averages are 3.4% and 2.5% respectively and the current 12-month trailing default rate for European speculative bonds is 0.9% compared to 2.7% in

FIGURE 5

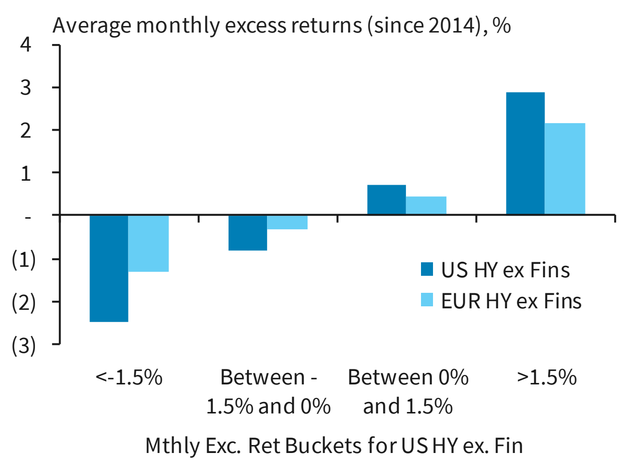
EUR vs. USD HY ex-fin markets: EUR market is smaller, but have better average rating and lower trailing default rate

Index	EUR HY ex-fins	USD HY ex-fins
Currency	EUR	USD
Amt Outstanding	€222bn	$1,127bn
# of Bonds	419	1,732
# of Issuers	238	806
Average Issue Size, €/$mn	530	651
Duration	3.3	3.4
Rating Mix	BB 63%, B 29%, CCC 8%	BB 42%, B 41%, CCC 15%
Top Three Sectors	Comm 28%, Cons Cyc 18%, Cap Goods 14%	Comm 22%, Cons Cyc 17%, Energy 16%
LTM Default Rate (Moody's)	0.9%	2.7%

Source: Bloomberg Barclays Indices, Moody's, Barclays Research

FIGURE 6

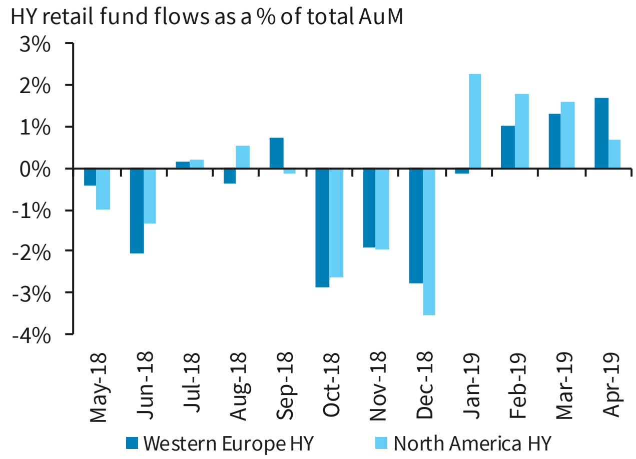
The average monthly excess returns for EUR HY have been of a lower beta to USD HY



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 7

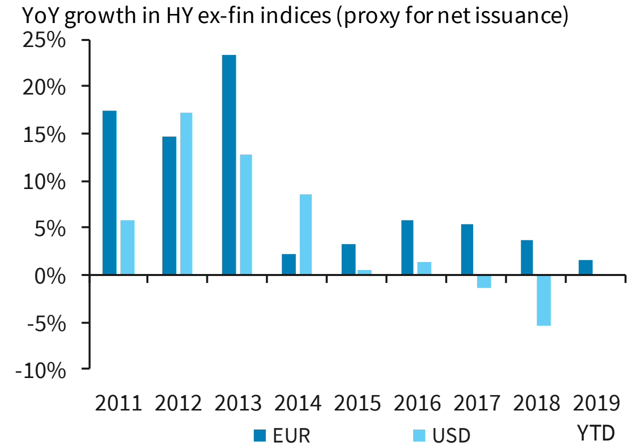
Strong retail outflows from USD HY in 4Q '18



Source: EPFR, Barclays Research

FIGURE 8

EUR vs. USD HY market growth



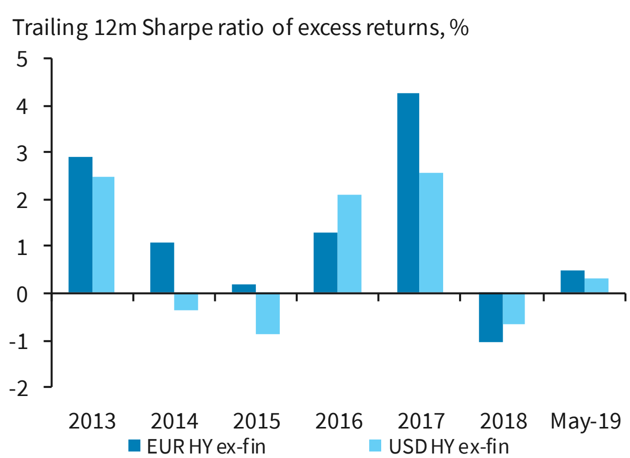
Source: S&P LCD, Bloomberg, Barclays Research

the US). A more accommodative market to credit investors in Europe compared to a more equity-friendly market in the US has likely also contributed to the higher average default rate in the US.

YTD, on a volatility-adjusted basis (Figure 9), EUR HY has returned more than USD HY. This is despite the flat USD HY growth YTD (having shrunk in the last couple of year (Figure 8)), though gross issuance has been stronger in USD HY than EUR HY (+1% and -19% respective YTD y/y growth; with the EUR market until recently seeing scarce B or CCC-rated issuance) and inflows, as a percentage of the size of the respective markets, have been marginally stronger into the European market. We expect demand for EUR HY bonds to be structurally supported by i) low core bond yields in Europe and Japan, and ii) unfavourable hedging costs to purchase USD-assets.

FIGURE 9

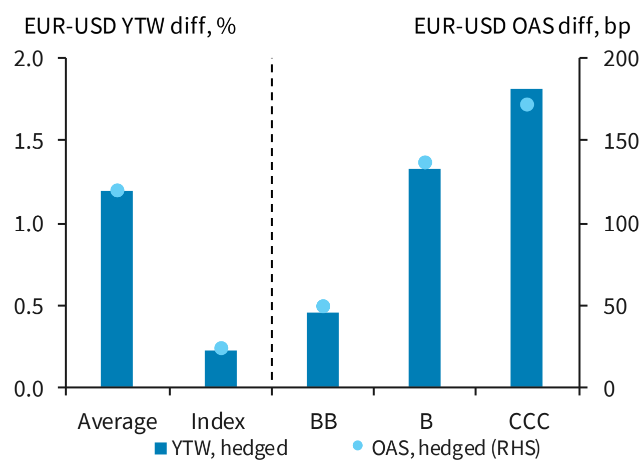
EUR vs. USD HY: Historical annual excess returns (adjusted for volatility)



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 10

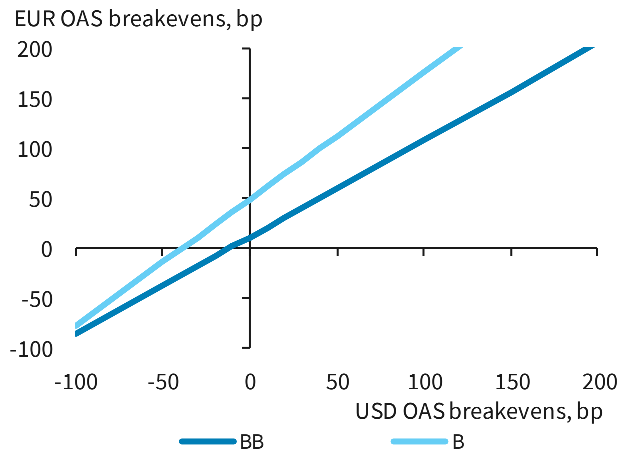
Current average yield and spread pick-ups are higher than at the index level due to the rating composition of indices



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 11

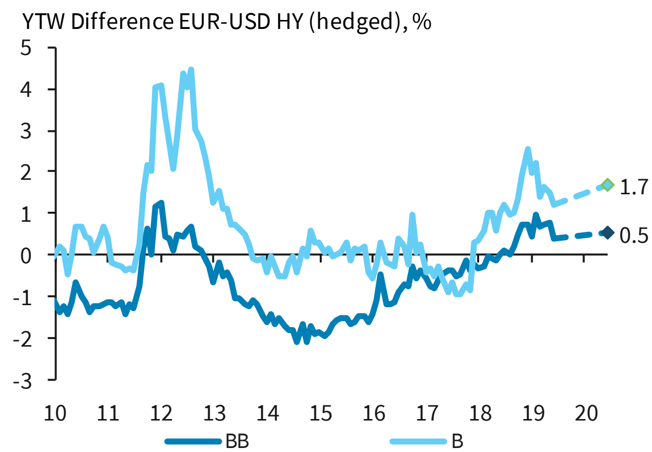
EUR HY BBs and Bs can widen 12bp and 54bp, respectively, (if USD spreads remain flat) to still breakeven on a yield basis



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 12

Breakeven levels for EUR HY vs. USD HY BBs and Bs on a hedged yield basis in a historical context



Source: Bloomberg Barclays Indices, Barclays Research

Valuation: On a hedged basis, EUR HY is a better carry

As noted above, and shown in Figure 10, the current hedged yield and spread pick-up for EUR HY vs USD HY bonds look attractive in absolute terms but also relative to history (Figure 1 and Figure 2).

What does this pick-up 'buy' in terms of buffer against further European weakness? In Figure 11 we show that the relative spread widening/tightening we can afford to see in the EUR HY vs. USD HY market in the next 12 months for the relative hedged yield of EUR HY to breakeven with USD HY.

EUR HY BBs and Bs can widen 12bp and 54bp, respectively, before the current carry of 0.5% and 1.2% for EUR-USD HY BBs and Bs trade, respectively, will be eroded completely. Conversely, suppose EUR HY does not move for 12 months, for USD HY to break even on a currency-hedged basis, US BBs would need to tighten 11bp and US Bs would need to tighten 39bp.

Note that we are agnostic of whether the moves come from government bond yields or HY spreads themselves. This means that for the case of US Bs, we need to see spreads tighten 39bp more than whatever rise in US treasury yields which is likely to happen amid this rally.

How do these break-evens look in a historical context? Suppose USD HY does not move and EU BBs and Bs widen to break even on a total return basis to the levels from above, where will US-EU BB and B differentials be? We show these "break-even equivalent differentials" in Figure 12.

This illustrates that if Europe was to experience another sovereign crisis a la 2012, the degree of underperformance witnessed historically will be far higher than the break-evens currently. However, European Bs in particular can see the EU-US differential move to levels similar to what was seen at the peak of recent EU underperformance and still break even.

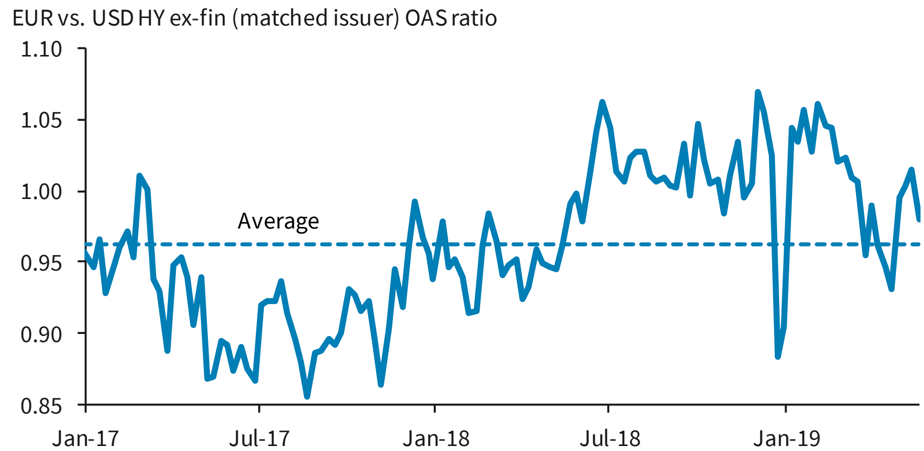
As such, we conclude that European HY is priced for some further underperformance vs US driven by weakening growth, but by no means priced for a resurgent sovereign crisis.

Observed biases: home issuers, quality and short duration

Having concluded that EUR HY has a meaningful pick-up over USD HY on a cross-currency basis at the index level, we take a closer look under the hood of the broad pick-up by looking at the spread and yield pick-up for matched issuers.

FIGURE 13

EUR HY vs. USD HY spread pick-up for matched issuers has compressed, but still above historical average



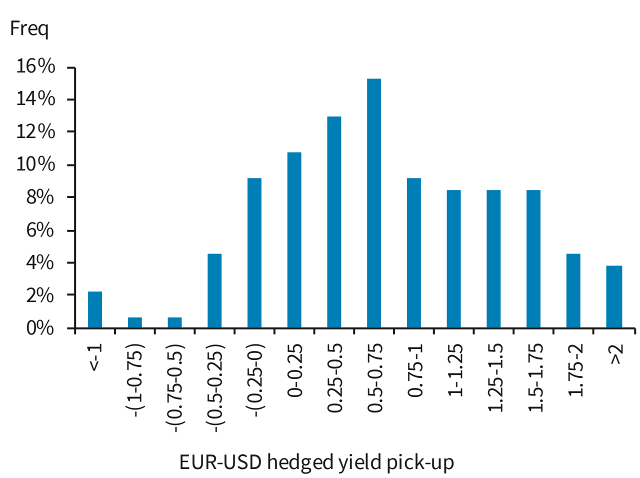
Source: Bloomberg Barclays Indices, Barclays Research

Using bonds in the USD HY ex-fin and EUR HY ex-fin universes, we found 76 matched tickers/issuers of which we then consider 130 EUR-USD bond pairs where the rating and maturity (up to 1.5 years' gap) matched. We examine the distribution of their hedged EUR-USD yield pick-ups (Figure 14) and found that the average pick-up is c.70bp and is considerably disperse in variation, though with a skew or significantly more pairs offering more yield in the EUR vs USD bond; 107 pairs or 82% offer more yield pick-up in EUR vs USD, with 22 pairs or 17% offering more than 1.5% pick up for the EUR vs USD bond.

We also note a number of trends for these pairs. As we noted in *Seeing value in EUR versus USD HY*, 19 October 2018, a home- or domestic-bias observed where relative EUR/USD spread ratio

FIGURE 14

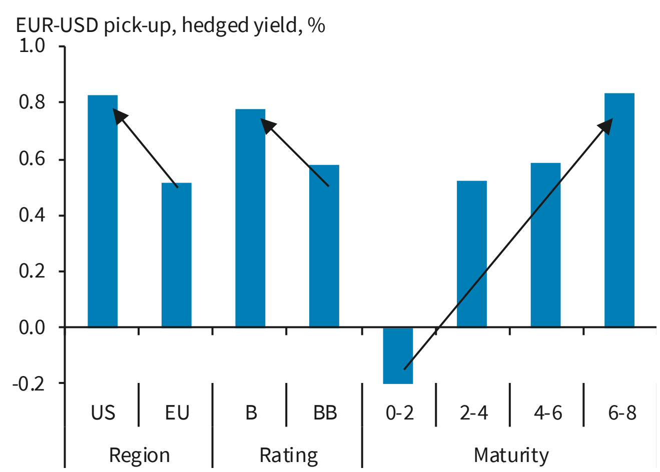
Pair-wise EUR-USD hedged yield pick-up is widely dispersed



Note: Basket of 130 pairs. Source: Barclays Research

FIGURE 15

US issuers have more pick-up in EUR, B more than BB, and longer-dated bonds have more pick-up



Note: Basket of 130 pairs. Source: Barclays Research is usually tighter (less than 1.0x) for domestic issuers. As Figure 16 shows, the EUR vs USD spread ratio for matched issuers (and thus eliminating broader macro risks that might be perceived as a reason preference to hold bonds in one currency vs the other) is persistently less than 1.0x for European issuers while the USD vs EUR spread ratio is persistently less than 1.0x for North American issuer; providing a structural opportunity for investors with a global mandate. Figure 15 shows that in the sample of 130 EUR-USD pairs, the pick-up is greater for US issuers in aggregate compared to European issuers.

We note that single B-rated issuers offer more pick-up on average than BB issuers, corroborating an up-in-quality bias observation we've seen in both markets, particularly in Q4 18 but as well during most of the rally this year (see *Musings for April*, 29 March 2019).

Additionally, pick-up is greater for longer-duration bonds (Figure 15), which (and the fact that the average EUR-USD pick-up is negative for 0-2Y bonds) supports our view that yield curve is steep in Europe and is near historical highs (Figure 17); and anecdotal comments that structural demand for short-duration bonds have been very strong.

Results: 1-0, we prefer EUR HY to USD HY

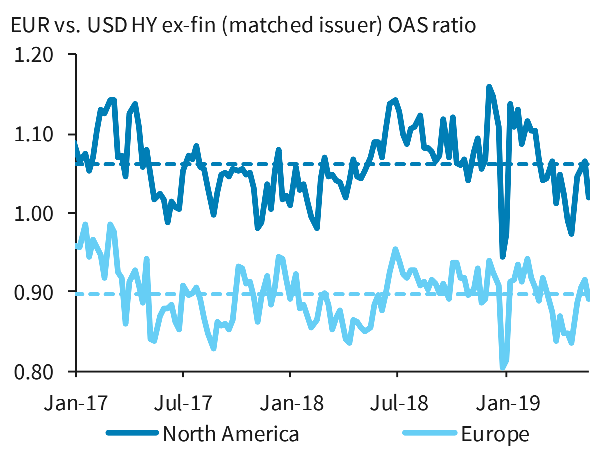
The above analyses tell us that while there are pockets of value in both markets, we prefer EUR to USD HY on a thematic level given attractive yield and spread pick-up on a hedged basis in aggregate and across rating buckets and we would rather be positioned in a lower beta (EUR HY) market given the rally YTD, downside risks ahead and our base case for some *spread widening* by year-end in both markets.

As flagged above, we also think that low core bond yields in Europe and Japan for an indefinite period reviving and prolonging the "search for yield" environment and high hedging cost for foreign investors to purchase USD assets will be structurally supportive of demand for EUR HY assets.

However, we caveat that this preference rests on broad realisation of our house base case view of growth for the eurozone and globally over the next 12 months. The obvious risks would be the relative *weak growth in the Eurozone compared to the US* (though US growth is also expected to normalise from 3Q this year as effects from fiscal policies wane) and

FIGURE 16

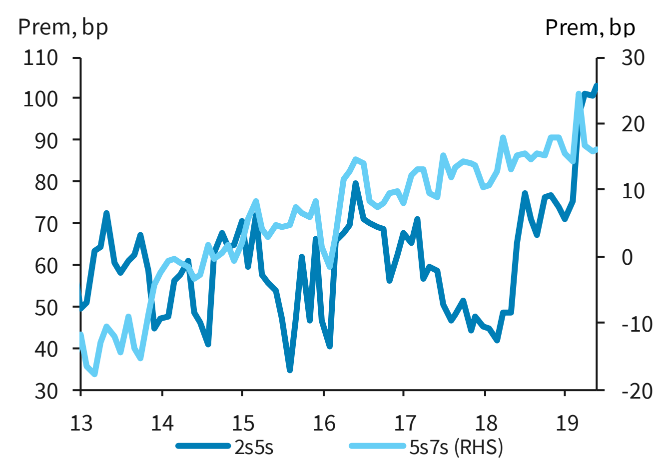
Home-bias: domestic issuers tend to trade at a relative discount to foreign issuers



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 17

EUR HY: Premium for moving up in duration is steepest in recent years



Note: For more on the calculations of curve premium above, please see *Seeing through the haze with a factor model*, 2 November 2018.
Source: Bloomberg Barclays Indices, Barclays Research

vulnerability of the region's growth to uncertainties surrounding (as well as the final outcome of) US-China and US-EU trade negotiations, as well as persistent geopolitical risks on the continent, particularly those surrounding Italy and Brexit. That said, should our growth expectations (of 1.2% and 1.4% for 2019 and 2020, respectively, for the eurozone and c. 3.6-3.7% for 2019-20 globally) materialise, we think EUR HY provides a better carry, particularly on a hedged basis compared to USD HY. We would be cautious if recession (not our base case for this year) risks rise materially for Europe.

Screening for EUR-USD pairs with the highest hedged yield pick-up

In Figure 18 and Figure 19, we highlight EUR-USD bond pairs with the highest hedged yield pick-up for. Figure 18 shows the highest hedged yield pick-up for swapping out of a USD bond into the EUR bond of the same issuer. We have also removed pairs where the cash price differential is more than 0.5 points higher for the EUR vs. USD leg. Vice versa, Figure 19 shows the highest hedged yield pick-up for swapping out of a EUR bond into the USD bond of the same issuer. Unsurprisingly, the broader market valuations and, importantly, the annualised EURUSD hedging cost at 3.1% mean that there is currently more USD-into-EUR swaps with a positive hedged yield pick-up than EUR-into-USD swaps.

FIGURE 18

Screen I: Highest hedged yield pick-up for swapping out of USD into EUR bonds

EUR Bonds							USD Bonds							Differential, EUR vs. USD (hedged)		
Security	Mat	Price	OAS, bp	YTW, %	Average Rating	Security Type	Security	Mat	Price	OAS, bp	YTW, %	Average Rating	Security Type	Price	OAS, bp	YTW, %
TTMTIN 2.2 01/15/24	4.6	88.0	566	5.1	BA3	Sr Unsecured	TTMTIN 5 5/8 02/01/23	3.7	99.1	339	5.9	BA3	Sr Unsecured	11.0	245	2.3
IRM 3 01/15/25	5.7	101.2	270	2.6	BA3	Sr Unsecured	IRM 6 08/15/23	4.2	102.5	116	3.6	BA3	Sr Unsecured	1.3	173	2.1
BHCCN 4 1/2 05/15/23	4.0	101.2	341	3.3	B3	Sr Unsecured	BHCCN 5 1/2 03/01/23	3.8	100.9	178	4.3	B3	Sr Unsecured	-0.3	181	2.0
SHAEFF 2 3/4 09/15/21	2.3	101.3	281	0.8	BA1	1st lien	SHAEFF 4 1/8 09/15/21	2.3	101.7	114	1.9	BA1	1st lien	0.4	184	2.0
SGMS 5 1/2 02/15/26	6.7	95.0	668	6.4	CAA1	Sr Unsecured	SGMS 8 1/4 03/15/26	6.8	102.8	499	7.5	CAA1	Sr Unsecured	7.8	189	2.0
FINRSK 6 7/8 11/15/26	7.5	100.3	675	6.8	B3	Sr Unsecured	FINRSK 8 1/4 11/15/26	7.5	101.2	522	7.9	B3	Sr Unsecured	0.9	173	2.0
POWSOL 4 3/8 05/15/26	7.0	102.1	406	3.9	BA3	Secured	POWSOL 6 1/4 05/15/26	7.0	104.3	275	5.3	BA3	Secured	2.2	151	1.7
BMC 8 3/8 09/01/26	7.3	97.8	881	8.8	CAA2	Sr Unsecured	BMC 9 3/4 09/01/26	7.3	97.5	758	10.2	CAA2	Sr Unsecured	-0.3	143	1.6
SGMS 3 3/8 02/15/26	6.7	98.5	382	3.6	B1	1st lien	SGMS 5 10/15/25	6.4	99.6	257	5.1	B1	1st lien	1.1	145	1.6
ATCNA 7 1/4 05/15/22	3.0	102.0	524	4.5	CAA1	Sr Unsecured	ATCNA 7 3/4 05/15/22	3.0	101.6	347	6.0	CAA1	Sr Unsecured	-0.4	195	1.6
CAR 4 1/2 05/15/25	6.0	103.9	340	3.5	B1	Sr Unsecured	CAR 6 3/8 04/01/24	4.9	103.7	235	5.0	B1	Sr Unsecured	-0.2	125	1.6
NFLX 4 5/8 05/15/29	10.0	109.0	366	3.5	BA3	Sr Unsecured	NFLX 6 3/8 05/15/29	10.0	109.8	272	5.1	BA3	Sr Unsecured	0.8	115	1.5
FINRSK 4 1/2 05/15/26	7.0	101.4	425	4.2	B2	1st lien	FINRSK 6 1/4 05/15/26	7.0	102.0	318	5.7	B2	1st lien	0.5	127	1.5
BHCCN 4 1/2 05/15/23	4.0	101.2	341	3.3	B3	Sr Unsecured	BHCCN 5 7/8 05/15/23	4.0	100.9	232	4.9	B3	Sr Unsecured	-0.2	127	1.5
NFLX 3 7/8 11/15/29	10.5	104.0	349	3.4	BA3	Sr Unsecured	NFLX 5 7/8 11/15/28	9.5	105.7	272	5.1	BA3	Sr Unsecured	1.8	97	1.4
NFLX 3 7/8 11/15/29	10.5	104.0	349	3.4	BA3	Sr Unsecured	NFLX 6 3/8 05/15/29	10.0	109.8	272	5.1	BA3	Sr Unsecured	5.8	97	1.4
CSTM 4 1/4 02/15/26	6.7	102.4	353	3.5	B2	Sr Unsecured	CSTM 6 5/8 03/01/25	5.8	103.1	274	5.4	B2	Sr Unsecured	0.8	99	1.2
SIGHCO 5 3/4 05/15/26	7.0	92.6	736	7.1	B3	Sr Unsecured	SIGHCO 7 7/8 05/15/26	7.0	93.5	668	9.2	B3	Sr Unsecured	0.9	88	1.0
BBDBCN 6 1/8 05/15/21	2.0	107.0	309	2.5	B3	Sr Unsecured	BBDBCN 8 3/4 12/01/21	2.5	109.9	232	4.5	B3	Sr Unsecured	2.9	94	1.0
LHMCFI 4 3/4 05/22/25	6.0	101.4	451	4.4	B2	Secured	LHMCFI 7 7/8 12/20/23	4.6	103.9	393	6.5	B2	1st lien	2.4	78	1.0
TITIM 2 3/4 04/15/25	5.9	97.9	355	3.1	BA1	Sr Unsecured	TITIM 5.303 05/30/24	5.0	100.0	309	5.3	BA1	Sr Unsecured	2.1	65	0.9
ATCNA 8 05/15/27	8.0	101.2	767	7.7	CAA1	Sr Unsecured	ATCNA 10 1/2 05/15/27	8.0	102.2	724	9.9	CAA1	Sr Unsecured	0.9	64	0.8
TITIM 3 09/30/25	6.4	99.6	345	3.0	BA1	Sr Unsecured	TITIM 5.303 05/30/24	5.0	100.0	309	5.3	BA1	Sr Unsecured	0.4	55	0.8
CAR 4 1/8 11/15/24	5.5	103.7	265	2.7	B1	Sr Unsecured	CAR 6 3/8 04/01/24	4.9	103.7	235	5.0	B1	Sr Unsecured	-0.1	49	0.8
VMED 4 1/2 01/15/25	5.7	103.6	268	2.4	B2	Sr Unsecured	VMED 6 10/15/24	5.4	103.4	170	4.7	B2	Sr Unsecured	-0.1	118	0.7

Source: Bloomberg Barclays Indices, Bloomberg, Barclays Research

FIGURE 19

Screen II: Highest hedged yield pick-up for swapping out of EUR into USD bonds

EUR Bonds							USD Bonds							Differential, USD vs. EUR (hedged)		
Security	Mat	Price	OAS, bp	YTW, %	Average Rating	Security Type	Security	Mat	Price	OAS, bp	YTW, %	Average Rating	Security Type	Price	OAS, bp	YTW, %
HTZ 4 1/8 10/15/21	2.4	101.9	231	1.8	B3	Sr Unsecured	HTZ 6 1/4 10/15/22	3.4	97.4	474	7.1	B3	Sr Unsecured	4.5	226	2.2
ALTICE 9 06/15/23	4.1	103.5	296	2.2	CAA1	2nd lien	ALTICE 8 1/8 01/15/24	4.6	102.9	389	6.9	CAA1	2nd lien	0.6	75	1.6
HTZ 4 1/8 10/15/21	2.4	101.9	231	1.8	B3	Sr Unsecured	HTZ 5 7/8 10/15/20	1.4	99.9	311	5.9	B3	Sr Unsecured	2.0	63	1.1
SFRFP 5 5/8 05/15/24	5.0	103.1	204	1.3	B2	1st lien	SFRFP 6 1/4 05/15/24	5.0	102.4	261	5.4	B2	1st lien	0.8	39	1.0
BBDBCN 6 1/8 05/15/21	2.0	107.0	309	2.5	B3	Sr Unsecured	BBDBCN 6 10/15/22	3.4	98.5	393	6.5	B3	Sr Unsecured	8.5	68	0.9
HTZ 4 1/8 10/15/21	2.4	101.9	231	1.8	B3	Sr Unsecured	HTZ 7 3/8 01/15/21	1.7	100.1	332	5.5	B3	Sr Unsecured	1.8	84	0.6
LHMCFI 6 1/4 12/20/23	4.6	106.5	338	2.9	B2	1st lien	LHMCFI 7 7/8 12/20/23	4.6	103.9	393	6.5	B2	1st lien	2.6	35	0.4
EQIX 2 7/8 03/15/24	4.8	104.0	145	0.9	BA1	Sr Unsecured	EQIX 5 3/4 01/01/25	5.6	103.6	154	4.4	BA1	Sr Unsecured	0.4	-10	0.4
TDCDC 7 06/17/23	4.1	108.0	315	2.6	B3	1st lien	TDCDC 9 3/8 06/17/23	4.1	107.8	344	6.1	B3	1st lien	0.2	11	0.4

Source: Bloomberg Barclays Indices, Bloomberg, Barclays Research

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