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Seeing value in EUR versus USD HY

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The accelerated climb in US government benchmark yields brought an uptick in volatility to financial markets last week. However, their outpaced rise relative to other global rates has negatively impacted the relative value of USD fixed income assets for longer than that. Specifically, the rise in currency hedging costs for non-USD based investors has slowly eroded the value in US fixed income that would otherwise arise from a simple comparison of global nominal yields alone. We now find the European high yield market of particular value when compared to its US counterpart. Specifically, this relative value exists among bonds of differing currencies from the same issuer, allowing investors with a global mandate to avoid having to take a particular view on the credit and macro trends that could vary by geography.

To start, there are compositional differences between the European and US high yield markets (ex-fins) as noted in Figure 1. The EUR market is smaller, of reasonably higher quality (as indicated by ratings) and modestly shorter duration (although the duration differential between the two indices has compressed in recent years). To set the relative value discussion for investors who can invest across geographies, we track the YTW differential between the USD and EUR HY indices, both before and after currency hedging costs in Figure 2.

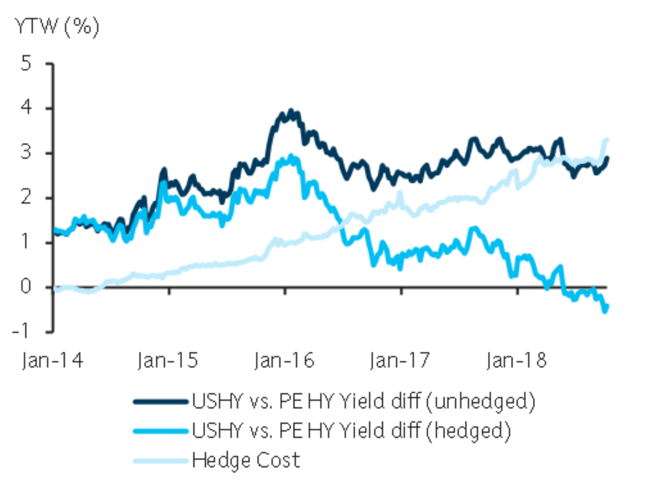
Putting the noted duration and constitutional differences aside, the divergence between USD and EUR Libor as well as the climb in the cross-currency basis given tighter USD funding through year-end have both negatively impacted the valuation argument of US HY for non-USD investors. That relative attractiveness peaked in early 2016, shortly after the Fed started its hiking campaign. Instead, USD-based investors should now find EUR HY attractive, all else equal. Indeed, the persistent rise in US nominal yields generally has paradoxically left US fixed income assets increasingly less attractive for investors around the world when purchased on a currency hedged basis. In line with the most common practice by investors who invest across geographies, we employ rolling 3m FX forwards to calculate the cost of currency hedge. For a full discussion on cross-currency hedge dynamics and estimating forward FX hedge costs, please see *Forward Thinking*.

FIGURE 1
EUR vs. USD HY, ex-fin comparison: EUR market is smaller, somewhat higher quality and has shorter duration

Index	EUR HY ex-fin	USD HY ex-fin
Currency	EUR	USD
Market Value, €bn	200	983
Number of Bonds	388	1,786
Number of Issuers	227	842
Average Issue Size, €mn	506	555
Average Duration, years	5.3	6.1
Average Duration, OAD	3.7	3.9
Average Liquidity Cost Score	0.9	1.1
Average Rating	BA3	B1
Average OAS	405	373
Average weighted OAS	372	363
Average Cash Price	100	98
Average YTW	3.9	6.9
Rating Breakdown (by par value)	BB 60%, B 34%, CCC 6%	BB 40% B 43%, CCC 16%

Source: Bloomberg Barclays Indices, Barclays Research

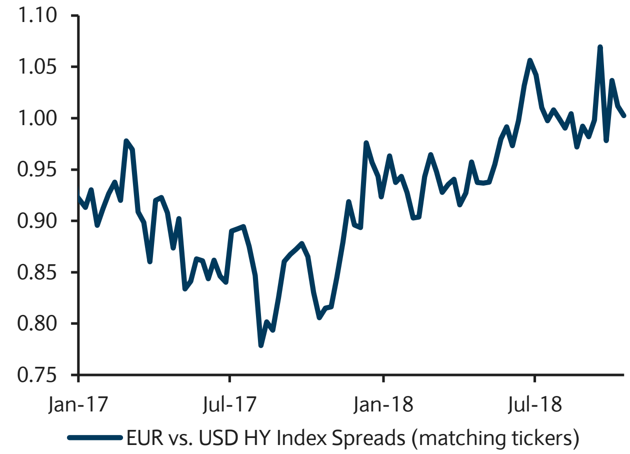
FIGURE 2
Rising hedge costs have dimmed the allure of US HY for the non-USD buyer base



Source: Bloomberg, Bloomberg Barclays Indices, Barclays Research

FIGURE 3

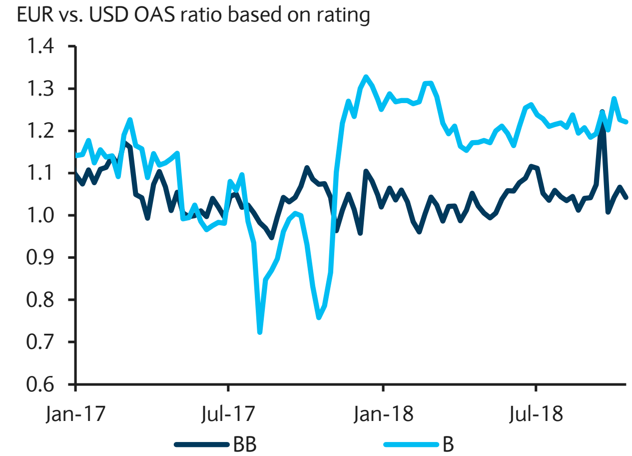
Ratio of EUR/USD spreads of matched issuers at their highest level over the past 18 months…



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 4

…but the spread ratio has cheapened up the most for matched Bs in EUR HY while being largely stable for BBs



Source: Bloomberg Barclays Indices, Barclays Research

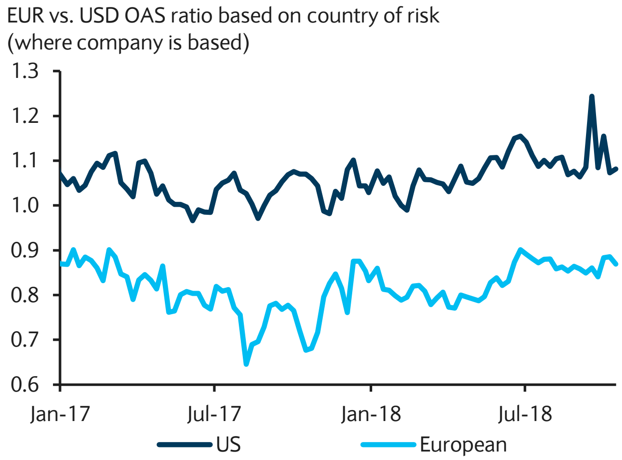
To look specifically at credit alone and to isolate any potential constituent differences, we track the ratio of spreads of matched issuers who have bonds outstanding in both the USD and EUR HY markets in Figure 3. Using the Bloomberg Barclays USD and EUR HY indices (modified, ex-financials and hybrids but inclusive of debt collectors), we created two indices for USD and EUR bonds where the issuers have both USD and EUR bonds outstanding. As the indices have not been rebalanced over time, there are fewer observations in the universe going back in history. Unlike the modest duration differential at the index level noted above, the cohorts of matched pairs both have duration of approximately 4.1. Because each issuer may have more bonds in one currency than the other (and of different debt tier), we note this to explain the difference in rating breakdown of the two indices in Figure 6.

While EUR spreads for these matched pairs outperformed for much of 2017, the ratio between the two cohorts has reversed and now sits at essentially the highest level of the past 18 months. This suggests to us that the relative value attractiveness of select EUR HY for USD investors rests on more than just the hedging dynamics noted above. Additionally, it guides EUR-based investors with a global mandate to realise value in their domestic market. Also, note that because we are tracking matched pairs (ie, bonds of the same issuer but of different currencies), we are essentially eliminating broader macro risks that investors may perceive between the two regions, which could otherwise drive relative value.

For the next level of analysis, we track the ratio of spreads by rating category in Figure 4. Spreads of matched pairs in the BB cohort have largely tracked each other in both the EUR and USD markets, with the current OAS ratio of bonds issued across currencies by the same issuers residing around 1.0x. Instead, the climb in the spread ratio noted in Figure 3 has been driven largely by the underperformance of single-B EUR bonds. There does not seem to be a particular sector driving the underperformance of EUR HY of these matched issuer pairs as we saw on aggregate broader spreads for EUR vs. USD bonds across sectors for the B-rated cohort (unlike the BB bucket for example, where there were a more equal number of sectors where the EUR bonds were trading wider vs. its USD bonds and those where the EUR bonds were trading tighter vs. its USD bonds).

FIGURE 5

Relative currency spreads ratio suggest home bias



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 6

Comparison of matching tickers universe – EUR vs. USD

Index	EUR HY ex-fin	USD HY ex-fin
Currency	EUR	USD
Market Value, €bn	97	148
Number of Bonds	154	203
Number of Issuers	77	77
Average Issue Size, €mn	568	676
Average Duration, years	5.8	6.5
Average Duration, OAD	3.7	4.4
Average Liquidity Cost Score	0.8	1.0
Average Rating	BA3	BA3
Average OAS	346	317
Average weighted OAS	320	313
Average Cash Price	102	99
Average YTW	3.5	6.4
Rating Breakdown (by par value)	BB 66%, B 31%, CCC 3%	BB 41% B 51%, CCC 9%

Source: Bloomberg Barclays Indices, Barclays Research

To determine if the domicile of the issuer itself drives any valuation bias by currency, we track the OAS ratio of two cohorts delineated by geography of matched issuer pairs in Figure 5. The EUR bonds of US-domiciled issuers have consistently traded cheap (ratio >1x) when compared to their USD bonds. Similarly, we find that the EUR bonds of European-based issuers have consistently traded rich (ratio <1x) when compared to their USD bonds. While there are technical factors by investment mandates that can keep these valuation divides in place, investors who are agnostic to marketplace and domicile of issuer should be considering the EUR bonds of US issuers in particular, but as well, the USD bonds of European issuers.

In Figure 7, we highlight ten EUR-USD pairs (from a longer list) where we think the EUR bonds offer attractive spread and yield pick-up, as well as a positive cash price difference when swapping out of the USD into the EUR bond. Using the universe of matched tickers above (Figure 3-Figure 6), we have tried to match bond pairs with the closest duration and that are from the same debt capital structure. We then calculate the OAS and yield to worst pick-up in USD-hedged value and ranked the list by the highest USD-hedged OAS pick-up for swapping out of the USD into the EUR bond. Finally, we removed names with a negative cash price difference (ie, swapping out of a cheaper bond into a more expensive bond) and highlight the top ten pairs. Note that many of these names are single-B rated by US issuers, consistent with our thematic relative value findings above.

The pairs discussed above are all for index-eligible bonds. One meaningful capital structure which is not considered above, as the USD bonds are not 144A is SOFTBK. Our analysts have recently initiated coverage on the company (*Initiating Coverage: Rapid Shift from Telecom-Focused to Technology Holding Company, 17 October 2018)* with a Market Weight rating on the EUR bonds and an Under Weight on the USD bonds. The main reason for the difference in ratings of the bonds is that the EUR bonds trade significantly cheaper than the USD bonds on a cross-currency hedged basis, with a pick-up in spread terms close to 150bp – far higher than the general BB-rated pick-up of approximately 55bp.

FIGURE 7

EUR-USD swaps with attractive spreads, yields and cash pick-up

Swap out of USD bond					Swap into EUR bond				
Security	Rating	Price	OAS, bp	YTW, %	Security	Rating	Price	OAS, bp	YTW, %
SGMS 10 12/01/22	CAA1	105	386	7.3	SGMS 5 1/2 02/15/26	CAA1	90	703	7.2
VMED 6 3/8 04/15/23	B2	103	180	5.3	VMED 4 1/2 01/15/25	B2	102	360	4.0
BMC 9 3/4 09/01/26	CAA2	100	615	9.7	BMC 8 3/8 09/01/26	CAA2	100	782	8.4
KRA 7 04/15/25	B3	100	342	6.9	KRA 5 1/4 05/15/26	B3	100	486	5.3
FINRSK 6 1/4 05/15/26	B2	100	272	6.2	FINRSK 4 1/2 05/15/26	B2	100	408	4.5
EQIX 5 3/4 01/01/25	BA2	102	189	5.3	EQIX 2 7/8 10/01/25	BA2	98	282	3.1
EQIX 5 7/8 01/15/26	BA2	102	202	5.5	EQIX 2 7/8 02/01/26	BA2	98	281	3.1
SIGHCO 7 7/8 05/15/26	B3	94	565	9.0	SIGHCO 5 3/4 05/15/26	B3	94	644	6.7
NFLX 5 7/8 11/15/28	B1	99	291	6.1	NFLX 3 5/8 05/15/27	B1	98	363	3.9
EQIX 5 3/4 01/01/25	BA2	102	189	5.3	EQIX 2 7/8 03/15/24	BA2	101	251	2.6

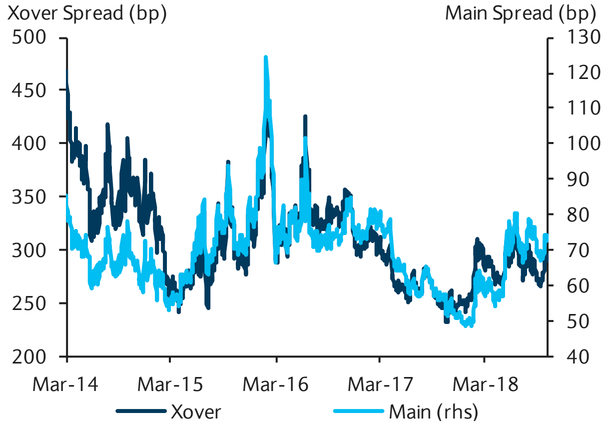
					Pick-up in USD hedged		
Ticker	Issuer	Debt Tier	Sector	Country of Issuer	OAS, bp	YTW, %	Cash Price Difference
SGMS	Scientific Games	Sr Unsecured	Gaming	US	**336**	3.23	14.77
VMED	Virigin Media Finance	Sr Unsecured	Media	UK	**198**	2.04	0.53
BMC	Banff Merger	Sr Unsecured	Technology	US	**186**	2.03	0.23
KRA	Kraton Polymers	Sr Unsecured	Chemicals	US	**163**	1.77	0.80
FINRSK	Refinitiv	1st lien	Technology	US	**154**	1.69	0.41
EQIX	Equinix	Sr Unsecured	Technology	US	**112**	1.13	3.12
EQIX	Equinix	Sr Unsecured	Technology	US	**98**	1.00	3.51
SIGHCO	Sigma	Sr Unsecured	Food and Beverage	Netherlands	**97**	1.13	-0.05
NFLX	Netflix	Sr Unsecured	Media	US	**91**	1.20	0.76
EQIX	Equinix	Sr Unsecured	Technology	US	**81**	0.59	0.47

Source: Bloomberg Barclays Indices, Bloomberg, Barclays Research

HY credit at a glance

FIGURE 8

iTraxx Crossover vs. iTraxx Main

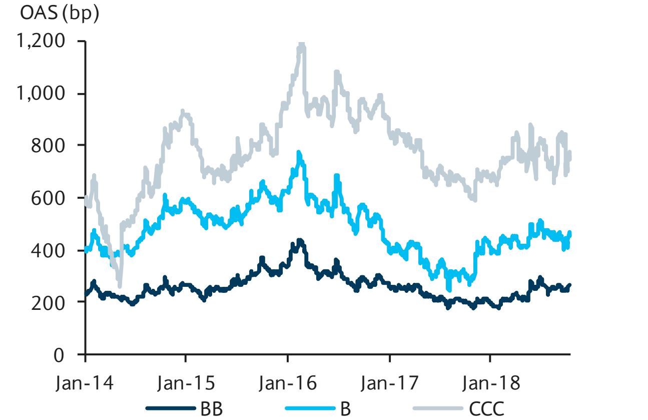


Please click *here* to see on Barclays Live.

Source: Markit, Barclays Research

FIGURE 9

Pan-Europe HY (ex-financials) spread by rating



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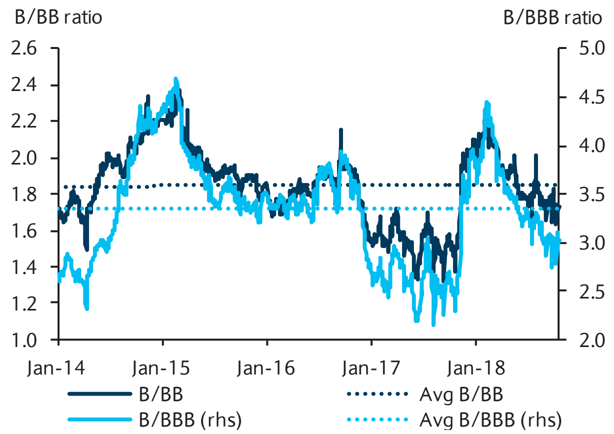
Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 10

Pan-Europe HY (ex-financials): B vs. BB and BBB ratios



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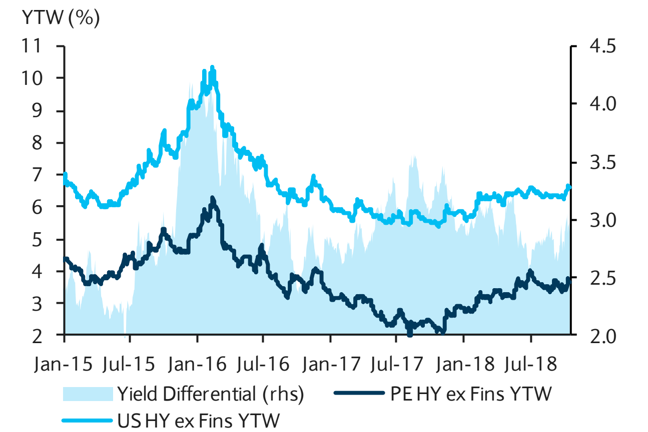
Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 11

Pan-Europe HY vs. US HY (ex-financials for both)



Please click *here* to see on Barclays Live.

Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 12

European HY issuance

Issuers:	All firms, in any European currency		European firms
Market:	Pan-European High Yield		US High Yield
Crncy:	€	£, CHF, other	$
WTD	0.0	0.0	0.0
MTD	1.6	0.0	0.4
YTD	49.0	4.1	9.5
YoY	-17%	-65%	+82%
YTD '17	59.4	11.6	5.2

Source: S&P LCD, Bloomberg, Barclays Research Note: Supply in billion.

FIGURE 13

European HY issuance monthly trends

Issuers:	All firms, in any European currency				European firms	
Market:	Pan-European High Yield				US High Yield	
Crncy:	€		£, CHF, other		$	
Year:	2017	2018	2017	2018	2017	2018
Jan	2.9	4.7	2.8	1.6		1.1
Feb	6.2	3.3	0.7	0.1	1.3	1.3
Mar	11.2	8.7	1.5	0.6	0.4	1.4
Apr	6.1	8.4	1.2	0.3		1.4
May	2.2	3.6	0.6	0.3	0.5	0.8
Jun	7.2	6.5	2.1		0.4	0.8
Jul	6.8	5.4	0.7		0.5	1.5
Aug		0.5				
Sep	9.1	6.6	1.8	1.3		0.6
Oct	13.0	1.6	1.1		2.6	0.4
Nov	7.8		0.5		1.1	
Dec	4.3		0.8		0.3	
Total	76.7	49.0	13.9	4.1	7.0	9.5

Source: S&P LCD, Bloomberg, Barclays Research Note: Supply in billion.

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Materially Mentioned Issuers/Bonds

BANFF MERGER SUB INC, A/CD/D/J/K/L/M
BMC 8 3/8 09/01/26 (EUR 100.08, 17-Oct-2018)
BMC 9 3/4 09/01/26 (USD 99.88, 17-Oct-2018)

EQUINIX INC, A/CD/CE/D/J/K/L/M/N
EQIX 2 7/8 02/01/26 (EUR 98.59, 17-Oct-2018)
EQIX 2 7/8 03/15/24 (EUR 101.08, 17-Oct-2018)
EQIX 2 7/8 10/01/25 (EUR 98.67, 17-Oct-2018)
EQIX 5 3/4 01/01/25, Market Weight (USD 102.13, 17-Oct-2018)
EQIX 5 7/8 01/15/26, Market Weight (USD 102.00, 17-Oct-2018)
Valuation Methodology: With its global data center footprint and leading interconnection strategy, Equinix is well positioned to meet the rapid growth in enterprise adoption of cloud and hybrid deployments. We expect spread compressions over time as the company executes its growth strategy.
Risks that May Impede Achievement of the Rating: Risks include unfavorable currency trends from strong USD, potential M&A/leveraging risk, and limited cash available for debt reduction after growth capex and funding dividend.

KRATON POLYMERS LLC / KRATON POLYMERS CAPITAL CORP, CD/J/K/M
KRA 5 1/4 05/15/26 (EUR 100.09, 17-Oct-2018)
KRA 7 04/15/25 (USD 100.13, 17-Oct-2018)

NETFLIX INC, CD/CE/J/K/N
NFLX 5 7/8 11/15/28, Market Weight (USD 99.13, 17-Oct-2018)
Valuation Methodology: Despite improving results, investors will likely continue to deemphasize Netflix's elevated (and rising) leverage as well as its sizeable content spend, which has caused cash flow to be meaningfully negative. Given the company's significant cash burn from content investment, we think Netflix will likely again be an issuer in the capital markets at some point. Trading in a YTW range of 4.4-6.1%, we see limited upside to current trading levels and view the structure as fairly valued.
Risks that May Impede Achievement of the Rating: Strong subscriber growth continues, ultimately resulting in significant cash flow generation and deleveraging.
NFLX 3 5/8 05/15/27 (EUR 98.90, 17-Oct-2018)

Refinitiv US Holdings Inc, A/CD/D/J/K/L/M
FINRSK 4 1/2 05/15/26 (EUR 100.47, 17-Oct-2018)
FINRSK 6 1/4 05/15/26 (USD 100.25, 17-Oct-2018)

SCIENTIFIC GAMES INTERNATIONAL INC, CD/J/K/M
SGMS 10 12/01/22 (USD 104.88, 17-Oct-2018)
SGMS 5 1/2 02/15/26 (EUR 90.36, 17-Oct-2018)

SIGMA HOLDCO BV, CD/J
SIGHCO 5 3/4 05/15/26 (EUR 94.10, 17-Oct-2018)
SIGHCO 7 7/8 05/15/26 (USD 93.38, 17-Oct-2018)

VIRGIN MEDIA FINANCE PLC, CD/D/E/J/K/L/M/N
VMED 6 3/8 04/15/23 (USD 103.20, 17-Oct-2018)
VMED 4 1/2 01/15/25, Market Weight (EUR 101.88, 17-Oct-2018)
Valuation Methodology: We rate Virgin Media bonds on an individual/relative value basis, taking into consideration current trading levels, maturity/duration and currency, among other factors. Virgin Media is the leading cable operator in the UK, and benefits from strong EBITDA generation as well as high free cash flow.
Risks that May Impede Achievement of the Rating: The competitive environment in the UK could deteriorate and negatively impact Virgin Media.

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For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to exceed the six-month total return of the relevant index.

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For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be in line with the six-month total return of the relevant index.

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For sectors rated against the Bloomberg Barclays U.S. High Yield 2% Issuer Capped Credit Index, the Bloomberg Barclays Pan-European High Yield 3% Issuer Capped Credit Index excluding Financials, the Bloomberg Barclays Pan-European High Yield Finance Index or the Bloomberg Barclays EM Asia USD High Yield Corporate Credit Index, the analyst expects the six-month total return of the sector to be less than the six-month total return of the relevant index.

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To view sector definitions and monthly sector returns for Asia, EEMEA and Latin America Research, go to https://live.barcap.com/go/research/EMSectorReturns on Barclays Live.

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Overweight (OW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to exceed the six-month expected excess return of the relevant sector.
Market Weight (MW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to be in line with the six-month expected excess return of the relevant sector.
Underweight (UW): The analyst expects the six-month excess return of the issuer's index-eligible corporate debt securities to be less than the six-month expected excess return of the relevant sector.
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Market Weight (MW): The analyst expects the six-month total return of the debt security subject to this rating to be in line with the six-month expected total return of the relevant sector.
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24% have been assigned an Underweight rating which, for purposes of mandatory regulatory disclosures, is classified as a Sell rating; 48% of bonds with this rating category are investment banking clients of the Firm; 72% of the issuers with this rating have received financial services from the Firm.

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Market Weight (MW):
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Underweight (UW):
The analyst expects the three-month excess return of the country's index eligible bonds to be less than the three-month excess return of the Bloomberg Barclays EM USD Sovereign Index.
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