

Seeing Value in EUR versus USD High Yield

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The accelerated climb in US government benchmark yields brought an uptick in volatility to financial markets last week. However, their rapid increase relative to other global rates has negatively affected 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 with 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 credit and macro trends that could vary by geography.

To start, there are compositional differences between the European and US high yield markets (ex-financials), as noted in Figure 1. The EUR market is smaller, of reasonably higher quality (as indicated by ratings), and has 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 yield to worst (YTW) differential between the USD and EUR High Yield 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 and the climb in the cross-currency basis given tighter USD funding through year-end have both negatively affected the valuation argument of US high yield 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 high yield 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 hedges. For a full discussion of cross-currency hedge dynamics and estimating forward FX hedge costs, please see [Forward Thinking](#).

Figure 1

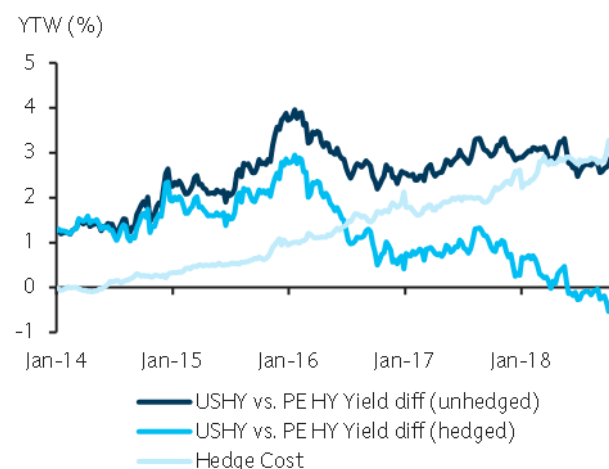
EUR versus USD High Yield, Ex-Fin Comparison: EUR Market Is Smaller, Somewhat Higher Quality, and Has Shorter Duration

Index	EUR HY ex-fin	USD HY ex-fin
Currency	EUR	USD
Market Value, \$bn	232	1,138
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

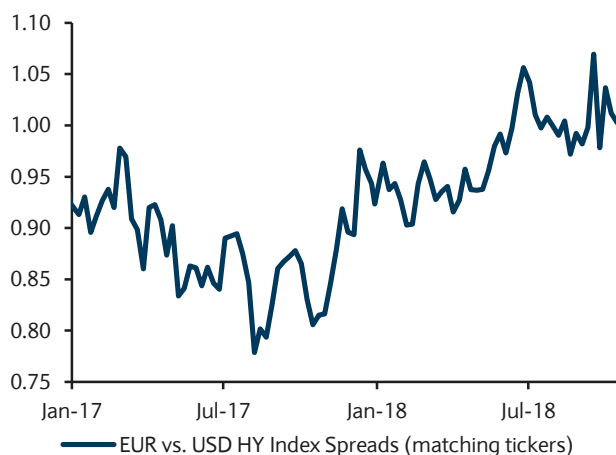
Rising Hedge Costs Have Dimmed the Allure of US High Yield for the Non-USD Buyer Base



Source: Bloomberg, Bloomberg Barclays Indices, Barclays Research

FIGURE 3

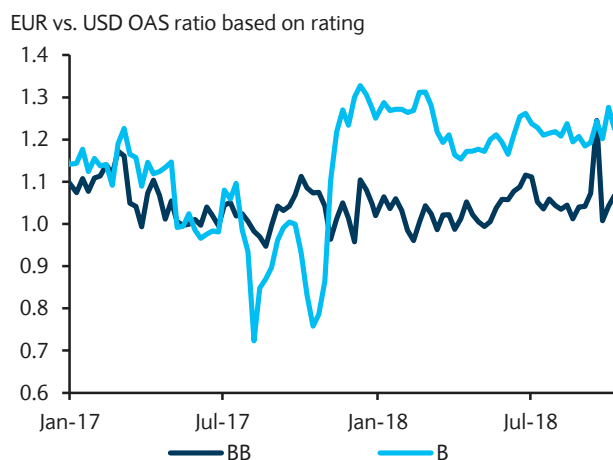
Ratio of EUR/USD Spreads of Matched Issuers at the Highest Level over the Past 18 Months...



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 4

...But the Spread Ratio Has Cheaped the Most for Matched Bs In EUR High Yield 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 that have bonds outstanding in both the USD and EUR high yield markets in Figure 3. Using the Bloomberg Barclays USD and EUR High Yield Indices (modified, excluding-financials and hybrids but including 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 durations of approximately 4.1. Because each issuer may have more bonds in one currency than the other (and of different debt tiers), we note this to explain the difference in rating breakdown of the two indices in Figure 6.

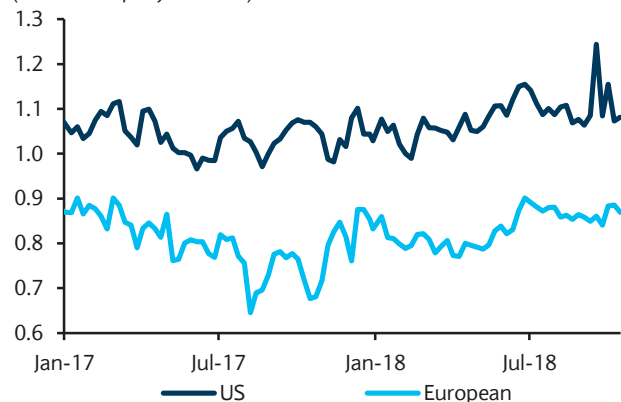
While EUR spreads for these matched pairs outperformed for much of 2017, the ratio between the two cohorts has reversed and now sits at essentially the highest level of the past 18 months. This suggests to us that the relative value attractiveness of select EUR high yield for USD investors rests on more than just the hedging dynamics noted above. In addition, it guides EUR-based investors with a global mandate to realize value in their domestic markets. Also, note that because we are tracking matched pairs (ie, bonds of the same issuer but 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 high yield for these matched issuer pairs, as we saw in the aggregate broader spreads for EUR versus USD bonds across sectors for the B-rated cohort (unlike the BB bucket, for example, where the number of sectors with EUR bonds trading wider than USD bonds and the number with EUR bonds trading tighter than USD bonds were closer to equal).

FIGURE 5

Relative Currency Spread Ratio Suggests Home Bias

EUR vs. USD OAS ratio based on country of risk
(where company is based)



Source: Bloomberg Barclays Indices, Barclays Research

FIGURE 6

Comparison of Matching Ticker Universe – EUR versus USD

Index	EUR HY ex-fin	USD HY ex-fin
Currency	EUR	USD
Market Value, \$bn	112	172
Number of Bonds	154	203
Number of Issuers	77	77
Average Issue Size, \$mn	658	783
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 the geography of matched issuer pairs in Figure 5. The EUR bonds of US-domiciled issuers have consistently traded cheap (ratio >1x) when compared with their USD bonds. Similarly, we find that the EUR bonds of European-based issuers have consistently traded rich (ratio <1x) compared with their USD bonds. While technical factors in investment mandates can keep these valuation divides in place, investors that are agnostic to the marketplace and domicile of issuer should consider the EUR bonds of US issuers in particular, but also the USD bonds of European issuers.

Figure 7 highlights ten EUR-USD pairs (from a longer list) where we think the EUR bonds offer attractive spread and yield pickup, 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 (Figures 3-6), we have tried to match bond pairs with the closest duration and that are from the same debt capital structure. We then calculated the OAS and yield to worst pickup in USD-hedged values and ranked the list by the highest USD-hedged OAS pickup for swapping out of the USD and 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 the thematic relative value findings above.

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

FIGURE 7

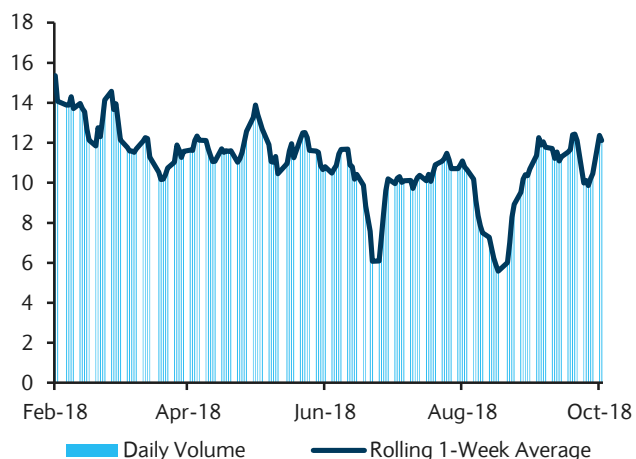
EUR-USD Swaps with Attractive Spreads, Yields, and Cash Pickups

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

Ticker	Issuer	Debt Tier	Sector	Country of Issuer	Pick-up in USD hedged		Cash Price Difference
					OAS, bp	YTW, %	
SGMS	Scientific Games	Sr Unsecured	Gaming	US	336	3.23	14.77
VMED	Virgin 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

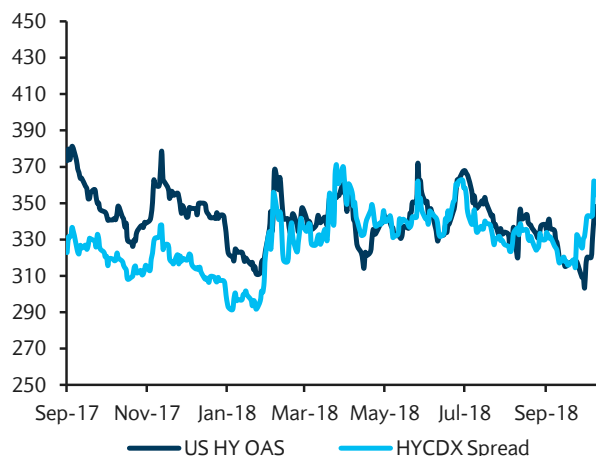
Source: Bloomberg Barclays Indices, Bloomberg, Barclays Research

High Yield Average Institutional Trade Volume (\$bn)



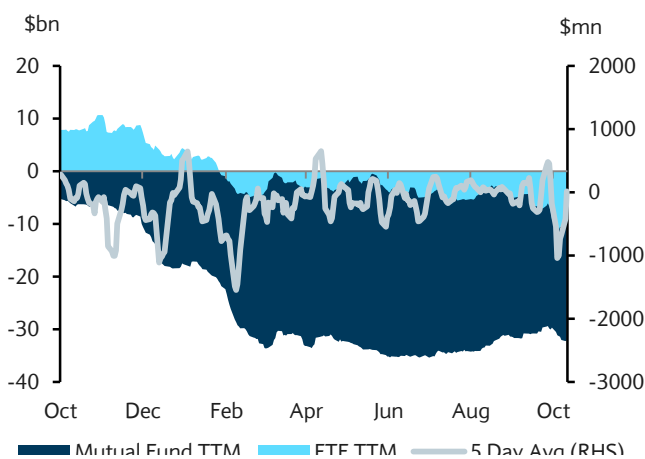
Note: Includes both registered and 144A volumes. Source: FINRA TRACE

On-the-Run HYCDX versus US High Yield Index (bp)



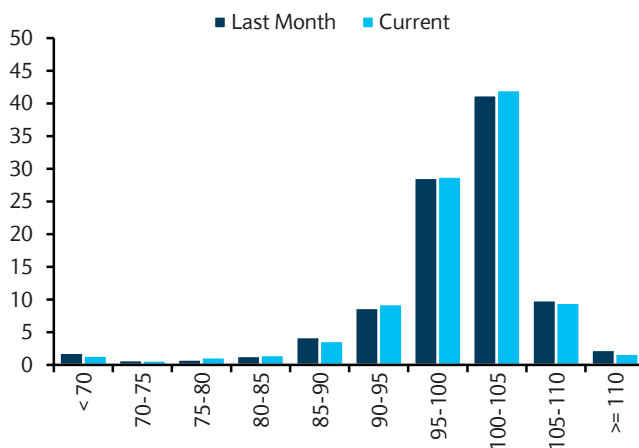
Source: Barclays Research

Flows to High Yield Mutual Funds and ETFs



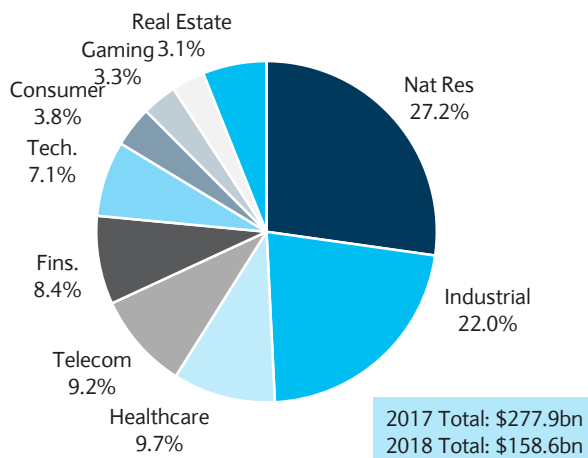
Note: Daily reporters only. Source: EPFR

High Yield Index Price Distribution by Par (%)



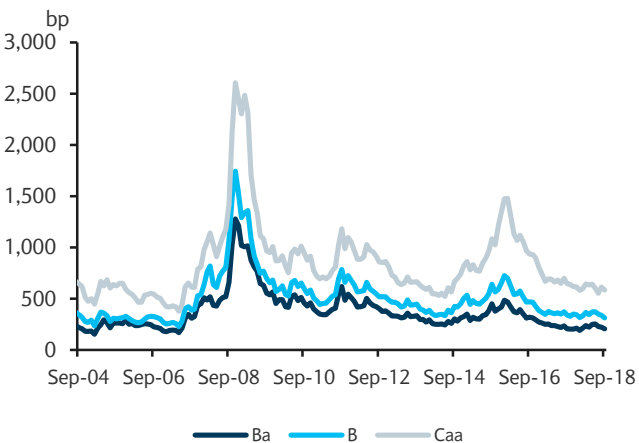
Source: Barclays Research

High Yield Supply by Sector



Source: Barclays Research

High Yield Spreads by Credit Quality



Source: Bloomberg Barclays Indices

Analyst Certification

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BANFF MERGER SUB INC, A/CD/D/J/K/L/M

BMC 8 3/8 09/01/26

BMC 9 3/4 09/01/26

EQUINIX INC, A/CD/CE/D/J/K/L/M/N

EQIX 2 7/8 02/01/26

EQIX 2 7/8 03/15/24

EQIX 2 7/8 10/01/25

EQIX 5 3/4 01/01/25, Market Weight

EQIX 5 7/8 01/15/26, Market Weight

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

KRA 7 04/15/25

NETFLIX INC, CD/CE/J/K/N

NFLX 5 7/8 11/15/28, Market Weight

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

Refinitiv US Holdings Inc, A/CD/D/J/K/L/M

FINRSK 4 1/2 05/15/26

FINRSK 6 1/4 05/15/26

SCIENTIFIC GAMES INTERNATIONAL INC, CD/J/K/M

SGMS 10 12/01/22

SGMS 5 1/2 02/15/26

SIGMA HOLDCO BV, CD/J

SIGHCO 5 3/4 05/15/26

SIGHCO 7 7/8 05/15/26

VIRGIN MEDIA FINANCE PLC, CD/D/E/J/K/L/M/N

VMED 6 3/8 04/15/23

VMED 4 1/2 01/15/25, Market Weight

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.

Market Weight (MW):

For sectors rated against the Bloomberg Barclays U.S. Credit Index, the Bloomberg Barclays Pan-European Credit Index, the Bloomberg Barclays EM Asia USD High Grade Credit Index or the Bloomberg Barclays EM USD Corporate and Quasi-Sovereign Index, the analyst expects the six-month excess return of the sector to be in line with the six-month excess return of the relevant index.

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.

Underweight (UW):

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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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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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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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