

THINGS MAY BE LOOKING UP FOR HIGH-YIELD BONDS

Euro denominated high-yield bonds are starting the new year on more solid footing than they ended in 2018.

2018 was a year to forget for many investors, including those in high-yield (HY) bonds. On both sides of the Atlantic, things went reasonably well for the first three quarters. In the last three months though, political uncertainty, tighter monetary policy and weaker corporate fundamentals, especially in some of Europe's bigger sectors, contributed to a strong and broad increase in risk aversion and financial-market volatility. Like their peers in equity markets, investors in high-yield bonds increasingly began to fret about growing recession risks.

With the benefit of hindsight, such fears are already starting to look a little overdone. Recent economic data points to continuing strong economic momentum in the United States. As a result, U.S. high-yield spreads have already tightened by 80 basis points (bps) since the beginning of the year. This shows how quickly prevailing market narratives can change.

Certainly, "there is no shortage in Europe of things that could go right," argues Per Wehrmann, Head of European High-Yield at DWS. This is not to deny that fundamental risk has increased. The default risk appears somewhat higher than in recent years, especially for issuers from structurally weak and cyclical sectors, such as retail, capital goods and construction, and from economically struggling countries, most notably the United Kingdom and Italy. Similar risks exist for issues with lower ratings and with material refinancing needs in the near future. Overall, however, default rates remain very low. "With still no recession in sight, we do not expect a sharp increase in default rates in the coming months, as the broad majority of issuers are fundamentally relatively solid and do not face short-term refinancing requirements," Per Wehrmann concludes. Our base case is that we would expect spreads to tighten over the next 12 months.



■ Euro high yield (option-adjusted spread vs. government bonds)

Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 1/10/19

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GLOSSARY / GLOSSAR

Basis point

One **basis point** equals 1/100 of a percentage point.

Default

Default is the failure to meet the legal obligations of a loan, for example when a corporation or government fails to pay a bond which has reached maturity. A national or sovereign default is the failure or refusal of a government to repay its national debt.

Default rate

The **default rate** refers to the proportion of borrowers who cannot service their loans.

Fundamentals

Fundamentals are data giving information about the general well-being of companies, securities or currencies and serving for the subsequent valuation of these as an investment opportunity.

High Yield (HY)

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

Monetary policy

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

Rating

A **rating** is a standardized assessment of the creditworthiness of the issuer and its debt instruments by specialized agencies. The main three rating agencies are the Moody's (Aaa over Baa1 to C, best to worst), S&P (AAA over BBB+ to D, best to worst) and Fitch (AAA over BBB+ to D, best to worst).

Recession

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

Spread

The **spread** is the difference between the quoted rates of return on two different investments, usually of different credit quality.

Volatility

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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