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High yield default expectations in Europe buck the trend

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- **Defaults in the European high yield market are currently at rock bottom**
- **Improving conditions across multiple themes are combining to boost optimism, from refinancing levels and gas prices to China reopening**
- **This is resulting in changing fortunes for different sectors including autos and chemicals**

As we approach the end of Q123, the European High Yield (EHY) market continues to defy expectations. In 2022, the outlook for the asset class was slightly concerning: Deutsche Bank was predicting a default rate of 3.8%[1]. Despite the concern, less than 0.5% of the EHY market has actually defaulted in the past year – which is some way under the long-term default average of almost 2%. Indeed, the market is now converging towards a 2% default scenario for 2023, with JP Morgan having recently revised down its default rate[2].

There are multiple themes in play that can explain this:

- Easing natural gas prices following a milder winter and European efforts to fill gas storage facilities
- Corporate results holding up better than expected
- The boost from China reopening following the abandonment of Covid lockdowns
- Corporate balance sheets in good shape, with interest coverage (EBITDA[3] to interest expense) near all-time highs

These themes have had favourable knock-on effects in multiple sectors. Auto original equipment manufacturers were plagued by rising raw material costs and supply-chain constraints in 2021/22 following Covid and protracted Chinese lockdowns, but these pinch points are now easing. Carmakers benefitted in 2022 as demand, outweighing supply-chain

[1] Reuters, U.S. high yield defaults to peak at 10.3% in 2024 - Deutsche Bank, 7 June 2022

[2] JP Morgan, State of the high yield market, 5 January 2023

[3] EBITDA: earnings before interest, taxes, depreciation and amortisation

constrained production, has allowed them to improve their sales mix with higher margin cars. This has also allowed manufacturers to raise prices while keeping tight control on cost pass-throughs to suppliers. Automakers enter 2023 with substantial order books that should support performance despite increasing uncertainty over consumer demand.

The European chemicals sector has also benefitted from these themes. Looking back, the surging natural gas prices we saw in 2022 necessitated de-stocking within end users, meaning some chemicals companies resorted to plant closures. However, as of March 2023 natural gas prices have fallen by more than 80% from their peak[4] and are around a third lower than at the start of 2022. As such the once feared deep recession scenario is now out of mind and the sector has seen a pickup in demand from the industrial sector. Europe's industrial sector is also expected to benefit from a pickup in demand from a reopening China. Acting as a bellwether for the sector, UK petrochemicals manufacturer INEOS reported that end markets are recovering from de-stocking cycles and it is anticipating mid-cycle conditions by the middle of 2023 – welcome news in the context of the environment we faced in mid-2022.

Another favourable dynamic for Europe is the lack of upcoming bond maturities in 2023. As of mid-March, less than €13 billion of bonds are due to mature this year. This represents only slightly more than 2.5% of the market value[5] – a very manageable amount given strong liquidity offsets any near-term concerns. Further out, 2024 and 2025 present greater challenges with 9% and 15% of market value maturing respectively[6]. However, we expect this challenge to be at least partially addressed as a result of more prudent and proactive issuers addressing their medium-term maturities well in advance. The default outlook is also supported by issuers striking deals with bond investors to extend their current maturities in return for financial incentives.

All in all, the EHY market is defying expectations, benefitting from favourable tailwinds and looking resilient in the medium term. While we remain cautious of cyclicals, such as autos and chemicals, the recent direction of travel has been promising.

[4] Bloomberg, European Gas Is Stuck in Storage After Prices Sank From Peak, 13 February 2023

[5] Bloomberg/Columbia Threadneedle Investments' analysis, as at 15 March 2023

[6] Bloomberg, as at 23 March 2023

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