Global High Yield Perspectives
2Q 2015 Outlook

CAPITALIZING ON EUROPEAN REFLATION

- Our Global Credit strategies are positioned to take advantage of European reflation
- The European Central Bank’s (ECB’s) balance sheet is growing again
- Economic surprise, sentiment, fundamental economic data are showing improvement
- Competitiveness and high unemployment in the euro zone will take time to improve
- Specifically targeting European high yield credit and high yield mortgages

The ECB balance sheet is once again growing while the Federal Reserve’s balance sheet levels will most likely be static (see Figure 1 below and Figure 2 on the next page). Quantitative easing in Europe has begun in earnest with purchases of sovereign, agency, and asset-backed debt – driving core euro-zone safe-haven yields to negative levels at maturities as long as seven years. Even short-term debt yields from some peripheral countries, like Spain, are negative. At the same time, the euro has depreciated, improving competitiveness and the terms of trade. Negative nominal interest rates, improving confidence, and a cheaper currency that is the result of ECB stimulus present an excellent financial backdrop for Europe to improve.

Figure 1  ECB Balance Sheet Is Growing
As of 3/25/2015, January 2007 balance-sheet levels rebased to 100

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Rebased as Jan 2007=100
Source: Brandywine Global, Thomson Datastream
Not unexpectedly, economic surprise indices are moving upward in Europe (see Figure 3). Economic data are performing better than market expectations, and, alongside improving inflation expectations, rallying equities, and money/credit growth provide an early indication of economic recovery.

**Figure 2** ECB Balance Sheet Is Growing – through purchases of ABS, too
As of 4/6/2015

**Figure 3** European economic data continues to surprise the market
In weighted avg std dev units (data vs. Bloomberg consensus)

Source: Bloomberg, Citigroup

Source: Thomson Datastream, Brandywine Global
Most importantly, the rapid pace of forced deleveraging has stopped. Bank activity is crucially important in Europe where banks represent a much larger portion of lending relative to capital markets than in the U.S. Markets seem to agree that banks are done deleveraging, reflected in tighter credit spreads and improved equity valuations in the sector. We feel this environment should encourage credit disintermediation to take place; capital markets are starting to play their proper role in Europe. We are starting to see the process of disintermediation unfold (see Figures 4A-C), but the process has moved at a slow pace recently.

**Figure 4A** Deleveraging has stabilized and disintermediation is taking place
Euro-zone bank balance sheets, total decline; in € tn

**Figure 4B** Euro Area: Non-Financial Corporate Indebtedness
€ tn; As of 3/31/2014

**Figure 4C** Non-Financial Corporate Bond Issuance
$ billion

Charts have been obtained by IIF and RBS Credit Strategy which Brandywine Global believes to be accurate and reliable.
Issuers that have traditionally had bank-debt-only capital structures are coming to market with bonds. New-to-market issuers need to offer additional compensation given markets participants’ unfamiliarity with the issuer. Owning the right credits that emerge as a means of disintermediation can be quite lucrative.

We believe the opportunity to earn idiosyncratic alpha through security selection will continue to improve (see Figure 5).

These idiosyncratic opportunities in Europe will continue to persist until peripheral risk premia for small business converge to levels seen in core European countries. We continue to monitor these risk premia as they will indicate when the value opportunity in European risk premia has been exhausted (see Figure 6).

Importantly, fundamental attachment points compare very favorably relative to the opportunities in the U.S. European High Yield net leverage is still below 3.5x, and risk premia appear more than suitable given the reflationary outlook.

High yield credit and high yield mortgage risk premia continue to be attractive investments for those who believe Europe will enter a positive feedback loop of better growth and better sentiment (see Figure 7).

One last front of uncertainty for high yield investors will come from private-equity investors. Prequin, a collector and analyzer of private-equity data, reports a large amount of private-equity money waiting on the sidelines to take advantage of distressed U.S. energy debt, equity, and specific assets. This large amount of investment dollars could initially be a negative force for current debt holders, as the risk of privately placed deals subordinating current bond holders could happen without significant warning. Any new capital structures put in place by private-equity firms will assuredly seek to subordinate existing bondholders.

When oil markets begin to stabilize, however, the large amount of private-equity assets on the sidelines could ignite a rush for distressed assets that raises financial asset prices and curbs excess costs to improve overall industry health. The timing for private-equity funds to start employing funds will be an important question for high yield investors to answer. On the other side of the coin, the potential for oil majors to buy-out energy assets would be an unmistakable benefit for high yield investors, since majors all have high investment-grade ratings.

We remain cautious with regard to buying U.S. energy high yield names in the current environment—although we believe the next two years will likely bring attractive opportunities. A top-down perspective on global growth and oil demand is important, but proprietary credit research, in our opinion, will be the most important factor for handicapping the turn in U.S. energy high yield assets. Understanding the private-equity cycle, avoiding credit impairment through subordination and default, and patience will all be crucial factors in generating excess return in high yield strategies moving forward.
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