HIGH YIELD MARKET UPDATE

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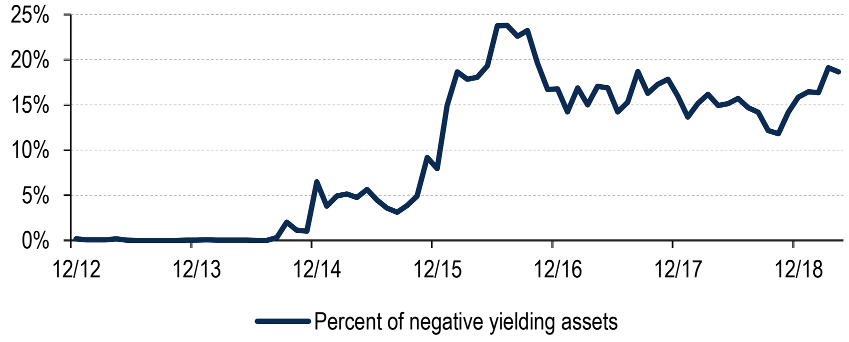
We wanted to take advantage of the recent pause in the rally that we have witnessed in the Global High Yield market from January to April 2019 to explore more in detail recent developments and mounting volatility due to Trade War discussions. As you will see in our analysis, technical and fundamentals factors are still positive and valuations, which were considered a bit expensive, are slightly less so today. At La Francaise, we still believe that we could see more volatility in the days / weeks to come because of trade war discussions, the political noise in Europe, Brexit, etc. Nevertheless, there could be interesting new entry points in this strategy for long-term investors.

CURRENT CONVICTIONS

1. TECHNICAL FACTORS: WELL ORIENTED

Technical factors are supportive of the credit market and the global high yield segment. As shown in the following graph, negative nominal yielding assets have continued to grow as a % of the total fixed income universe and are now approaching 20%.

Negative nominal yield assets weight (based on Global Fixed Income Index)

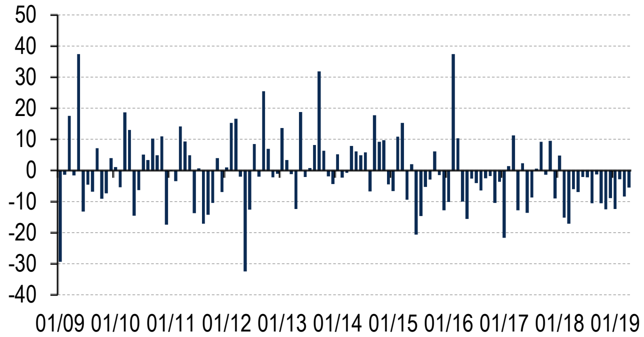


Source: BofAML, 04/2019

As we have mentioned in the past, the search for assets delivering positive yields with a relatively good liquidity will favor a carry product, especially High Yield and subordinated bonds (AT1 Cocos and Hybrids).

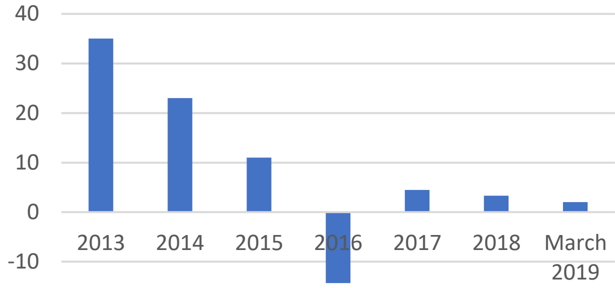
Another positive technical factor is Net Supply: the net supply of High Yield is widely negative in the US and flat in Europe (with a downward trend over the past three years). The factors that explain the decrease in net supply in the US and in Europe are the relative growth of new issues in the loan market versus the HY market and the increase in the number of rising stars. The combination of these two factors combined has limited the amount of available paper on the market.

US HY Net Issuance (in Bn USD)



Source: BofAML, 04/2019

Euro HY Net Issuance (Bn €



Source: JP Morgan 03/2019

No Fallen Angels and More Rising Stars

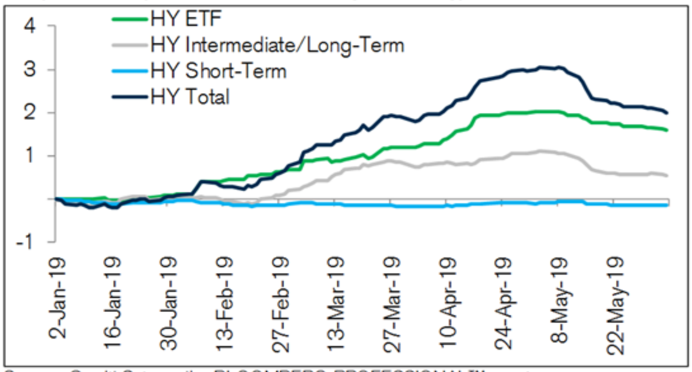
Source: Credit Suisse, 04/2019

Loan vs HY Market size (in USD bn)

Source: BofAML, US HY and Loans, 04/2019

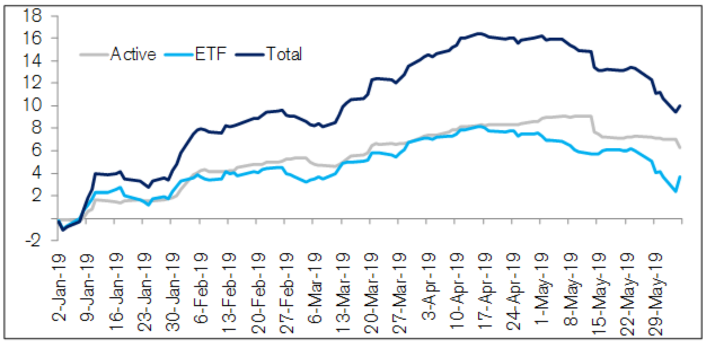
At the same time, inflows are coming back to the Euro and US High Yield markets, mainly in ETFs but also in open-ended funds. It is also important to note that there has been a decrease in recent inflows compared to the beginning of the year. (Source: Credit Suisse)

European HY corporate bond - YTD flow by fund sub-type, €bn



Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

USD HY corporate bond - YTD fund flow by sub-type, $bn

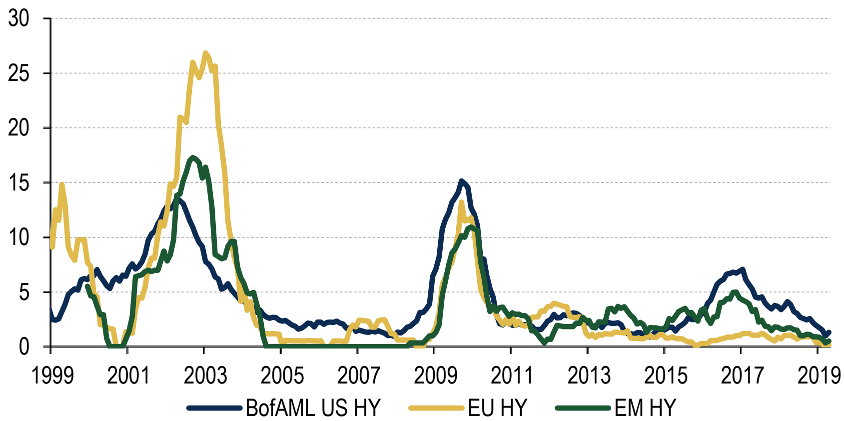


Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

2. FUNDAMENTALS: WELL ORIENTED, EVEN IF IDIOSYNCRATIC RISKS ARE ON THE RISE

High Yield default rates remain low in all geographic areas. In April, the Global default rate reached 0.74%, 1.30% in the US, 0.18% in Europe and 0.51% in Emerging Markets (Source: BofAML, 04/2019). Some specific (important in size) defaults in the US explain the slight rise in the US, but on a general basis, default rates should remain low in the coming months unless we encounter a global macroeconomic recession.

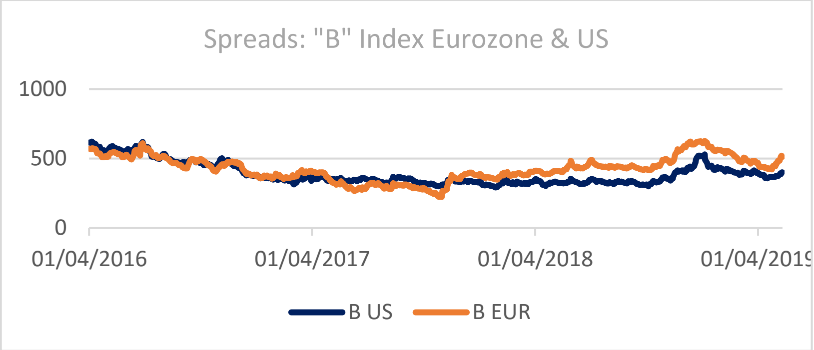
Default rates on a Global Scale



Source: BofAML, 04/2019

3. VALUATIONS: UP YTD BUT TRADING DOWN DURING TRADE WAR PERIOD…

We consider High yield bonds tobe a bit expensive in the US, especially for the riskiest issuers (CCC+), compared to their European Peers. We prefer to allocate to the Euro Zone where, as shown in the following graph, current spread levels, supported by the technical factors previously mentioned, lead us to believe that there could be some potential for spread tightening in the mid-term, especially for “B” names.



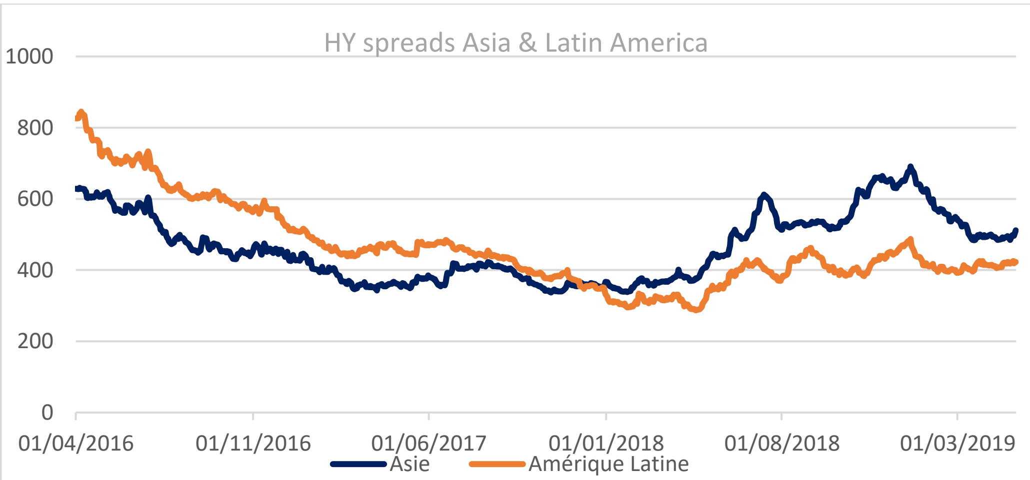
Source: Bloomberg, BofAML, 10/05/2019

The following table shows the results of La Francaise's credit valuation proprietary model (CRP). As illustrated in the far right hand column (Credit Risk Premia) , Single B rated bonds in EUR currently offer the best Risk adjusted /Yield ratio, a key measure for La Française given our long-term holding period in a Fixed Maturity Strategy. Emerging Market HY bonds come out in second place, which explains why we have been increasing our exposure to the region in the last months.

	Rating	Market size ($)	Issues	Yield to worst	Maturity to worst	Spread	Expected loss rate	Yield Premia	Credit Spread Premia
US	BBB	3 100 704	3 914	3,99	8,47	154	0,27	3,71	127
	BB	615 098	825	4,73	4,34	247	1,05	3,68	142
	B	507 406	753	6,53	3,82	427	2,59	3,93	168
	CCC	177 143	303	10,66	4,14	840	8,22	2,44	18
EUR	BBB	1 044 435	1 377	1,04	5,07	145	0,19	0,85	126
	BB	226 463	326	2,33	3,79	283	1,15	1,18	168
	B	62 995	124	4,84	2,65	541	1,25	3,6	417
	CCC	11 063	24	10,24	3,14	1080	7,79	2,46	301
Emerging	HY ($)	446 313	645	7,05	4,28	479	1,79	5,26	300

Source: La Française, April 2019

In the Emerging markets region, even though spreads have tightened since January, we continue to favor Asian HY over LATAM HY as shown in the following graph:



Sources: Bloomberg, BofAML, 10/05/2019

CONCLUSIONS

Technical factors are still positive and will in our view support the asset class, in particular in Europe. Negative yields, low government interest rates, a very low net supply in Europe, loans capturing flows, new inflows, etc. will all play a role in supporting the asset class.

Fundamental are quite positive too assuming the absence of an economic recession: low default rates, low refinancing needs for the next two years and overall good earnings.

Valuations have improved a bit but vary depending on the geographic region. We consider valuations to be relatively attractive in Europe and in some parts of the Emerging World like Asia, but less so in the US. Our geographic allocation is therefore over weighted on Eurozone HY and underweighted on US HY. In Emerging markets, we are overweight Asia versus Latin America.

In the short term, we are cautious and expect the market to remain volatile notably because of the trade war and Brexit. The primary risk that we have identified for the asset class is the ongoing trade war. If trade continues to be suspended and tension persist between the US and China, global growth could be stunted, and default rates could be on the rise which would negatively affect the HY market. For this reason, in terms of sectorial allocation, we continue to favor non-cyclical issuers and are particularly cautious on cyclical ones (chemicals, automobile, transport...) that could be affected by the Trade War.

Also, regarding the BREXT risk, we are trying to be very selective when it comes to UK names and focus only on “best in class” issuers.

Associated risks include: risk of loss of capital, discretionary risk, interest rate risk, credit risk relating to issuers of debt securities, default risk relating to issuers of debt securities, risks associated with investments in speculative high-yield securities, risks arising from investing in emerging markets, risk associated with holding convertible bonds, counterparty risk, subordinated debt risk, exchange risk, risk arising from techniques such as derivative products, conflict of interest risk, legal risk.

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