

Portfolio Manager Sandro Näf, of Capital Four Management Nordea 1 – European High Yield Bond Fund

LU0141799501 (BP-EUR) / LU0141799097 (BI-EUR)

Please note that the conference call occurred on the 5th of August 2020. All market commentary and information refers to the period before then

Key takeaways

- In Q2 2020, credit markets rebounded, with spread compression across the board
- The most recent default estimates seem to suggest a more positive backdrop versus previous expectations
- Flexibility to invest in credit asset classes beyond traditional high yield can be a robust way to navigate complex markets. As an example, CLOs and financial debt led the rebound in Q2 2020
- A successful holistic allocation to the broader universe of credit very much depends on selection skills and the ability to allocate to the most attractive opportunities the universe presents

You were one of the early investors in European high yield, how has the market and your Capital Four boutique developed over this time?

The market has evolved significantly. For example, when our Nordea strategy began in 2002, the size of the European high yield market was about €30-40bn. Today, it is about ten times this size. As for our Capital Four boutique, I experienced first-hand the launch of many focused and specialised high yield credit businesses in the US in the '80s and '90s and thought this could be enjoyable to create in Europe. Thankfully, Nordea agreed with us and provided support. We are now at 100 people and we still find it incredibly rewarding to invest in this market.

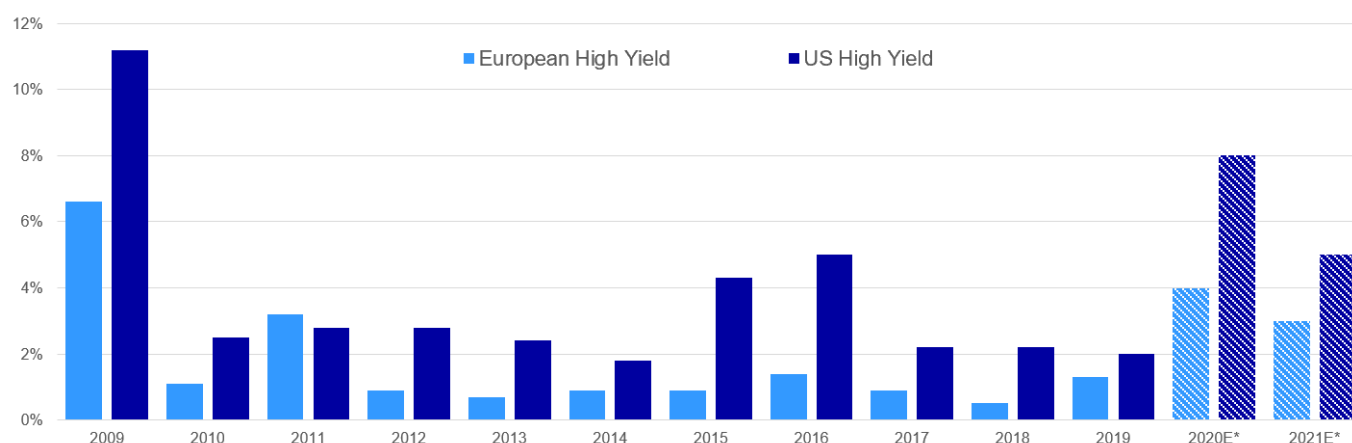
The market has witnessed extreme volatility in recent months, what is your view on where high yield stands currently?

The credit sell-off in March was almost unprecedented in its velocity. As investors, we always refer to the past and, in the case of high yield, this is the third recession – following 2001-02 and 2008-09. The '01-'02 recession was characterised by heavy defaults and 08-09 saw deterioration of the financial system, alongside the drying up of liquidity. In March this year, there were fears we could see the worst of both scenarios at the same time. However, the market soon realised financial conditions and defaults were not going to be as bad as initially feared. Investors have since begun to return, with retail flows coming into credit generally – as well as high yield specifically – in both Europe and the US.

You mentioned defaults, what do you expect for the remainder of the year and beyond?

In Europe, default rate expectations are currently at about 4% for this year and 3% next year. This cumulative 7% default expectation is significantly lower than in the last two major recessionary periods. The default expectations are higher in the US, largely due to the composition of the market, with higher exposure to sectors such as oil and broader commodities.

Historical and expected default rates



*Based on expectations from JP Morgan as of June 2020

Are you expecting opportunities from fallen angels?

Fallen angels have always been a favourite area for us to look for opportunities, particularly after a recession. Long-term statistical analysis reveals fallen angels deliver a very attractive risk-adjusted return, as the nature of the downgrades is far more favourable to the buyer than the seller. With the tremendous recent growth of BBB-rated credits globally, we expect €100bn of fallen angel supply in Europe for 2020 – which is huge when you consider the high yield market is currently only €400bn.

What is one of the most important aspects of investing in sub-investment grade credit right now?

We continue to see a wide dispersion of performance across the sub-investment grade spectrum. For example, some asset classes within financials delivered a double-digit return last year, while leverage loans only returned a third of this. This shows the importance of being flexible, as there are many more opportunities for investors to target within sub-investment grade credit now. These opportunities can be quite complex, so it does require investing in research capabilities, as well as quantitative tools and systems.

Return Dispersion Across Credit Asset Classes

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Financials	-43.78%	93.14%	15.52%	-9.71%	42.18%	13.53%	5.00%	1.40%	5.70%	9.06%	-3.06%	12.53%
Leveraged Loans	-30.67%	10.34%	4.76%	0.43%	8.60%	6.91%	3.50%	4.31%	5.46%	3.58%	1.51%	4.03%
EUR CLO BBB	-48.57%	46.85%	42.65%	-9.77%	46.05%	23.64%	9.56%	11.74%	10.42%	5.69%	-2.39%	5.53%
CDS - XOVER	-13.29%	26.03%	7.45%	-4.43%	19.77%	17.63%	7.84%	2.79%	2.98%	7.80%	-3.73%	6.77%
High Yield	-32.04%	79.96%	15.59%	-2.55%	28.56%	10.21%	5.33%	1.49%	9.15%	6.76%	-3.47%	10.16%
Short Duration	-13.76%	38.66%	10.60%	4.60%	8.76%	5.86%	1.83%	-0.53%	9.49%	2.79%	-0.57%	4.67%
Senior Secured	-28.58%	48.89%	13.51%	2.97%	15.68%	7.66%	2.95%	-0.31%	11.19%	5.10%	-3.15%	9.16%

Source: ICE Bank of America Merrill Lynch, Markit and Credit Suisse as of December 12, 2019. For Financials ICE Bank of America Merrill Lynch Euro Financial High Yield Index (HEB0) is used. For European High Yield European ICE Bank of America Merrill Lynch Currency High Yield Constrained Index (HPC0, EUR hedged) is used. For European senior loans the Credit Suisse Institutional Western European Leveraged Loan Index: Non-US-Denominated Loans is used. For CLO, BBB rated CLO is used. For CDS Xover, Markit iTraxx EUR is used. For short duration ICE Bank of America Merrill Lynch 1-3yr BB-B US Cash Pay Fixed Mat HY constr (J14H) is used. For Senior Secured ICE Bank of America Merrill Lynch BB-B Global HY Secured (HW4S) is used. **The performance represented is historical; past**

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