

Among high-yield issuers in the United States, "riskier credits have an increasingly difficult time raising money in the bond market", notes Gary Russell, High-Yield Portfolio Manager at Deutsche AM. "The decrease in liquidity combined with the low oil price has increased the expectations of defaults in the market." An additional negative factor are low recovery rates. According to Deutsche Bank research, the market may currently be pricing in an implied five-year cumulative default rate of almost 50% for U.S. high-yield bonds as a whole, assuming a 40% recovery rate. If, instead, a 20% recovery rate is assumed, that proportion falls to just under 40%. At the first glance, this may appear counterintuitive. The reason is that there are different ways to explain the same yield you observe on the market. In one case, you might imagine that many companies default, but default turns out to be not so bad, because for each default, the sale of each company's assets allows bondholders to recover a large chunk of what they would otherwise have gotten. In the alternative scenario, fewer companies default, but if they do, investors are only able to recover a smaller fraction of their losses.

Both default rates implied by above calculation look excessive, not least because of energy issuers' declining share of the market and because we do not, as yet, see the broader U.S. economic recovery as being at risk. However, the recent widening of spreads and deteriorating liquidity conditions imply that things may get worse for U.S. high yield before they get any better. As a result, Deutsche AM is expecting default rates to be around 7% in 2016. Consequently we are increasing the forecast spread we expect to see in U.S. high yield by December 2016 to 800 basis points. Spreads are currently at 790 basis points (as of January 21).

Simultaneously, we are revising our end-2016 call for euro high yield, to 500 basis points. Our overall view on euro high yield remains constructive, as we expect default rates to be only 2.5% in 2016.

With the exception of such international issuers as Petrobras* and Gazprom* from outside Europe, the Eurozone has little exposure to commodities-related companies, but higher rating quality and more robust investment flows. At the same time, Euro high yield has clearly seen some spill-over effects from the problems in the U.S. market. Contagion is also a risk for investment-grade bonds. Energy accounts for only 10 % of this market in the U.S. If oil prices stay low, that proportion is likely to shrink, partly because market values would shrink and partly because a growing number of riskier energy bonds would be downgraded. Indeed, some of the energy bonds recently downgraded from investment grade to junk stopped trading like investment-grade instruments well before the downgrade. In the short term, we expect forthcoming quarterly reports to show continuing trends of low earnings growth, slowly increasing leverage and weakening coverage measures. Key credit metrics (on a net-debt basis) remain in the middle of the historical range, but this adds little comfort as market-risk aversion increases. The recent spate of primary issuance has left support for the secondary market lukewarm at best. As in the high-yield segment, there are also strong signs of bifurcation; better credits have held up fairly well, while much of the selling is concentrated among less-credit-worthy issuers. Against this background, we remain positive on U.S. investment grade in the longer term. However, we are monitoring macro-economic developments carefully for signs of gloomier financial-market assessments impacting the real economy.

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