

In Perspective

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January 2012

High Yield: High hopes for 2012

AT A GLANCE

- Macro risks remain high; we start the year defensively positioned and expect coupon income to provide most of the return for 2012. However, if investors refocus on fundamentals there is decent scope for spread tightening
- Lower growth is likely to lead to a fall in earnings causing average leverage to rise. We expect defaults to increase, although not significantly
- Refinancing needs for 2012 look undemanding, but companies will continue to work towards reducing the refinancing hurdle of 2014-15
- Low interest rates should continue to increase the investor base for yield, which will help to absorb the new supply
- Dispersion will be high, so good stock selection will be vital. Cable and packaging remain favoured sectors

The extended period of slow growth and low interest rates, combined with reasonable corporate strength, is a good starting point for the European high yield market. However, as 2011 proved, these positive catalysts can be completely outweighed by an uncertain macro picture. Since the macro risks remain high, we start the year defensively positioned and expect coupon income to provide most of the return for 2012.

MACRO CONCERNS DOMINATE THE OUTLOOK

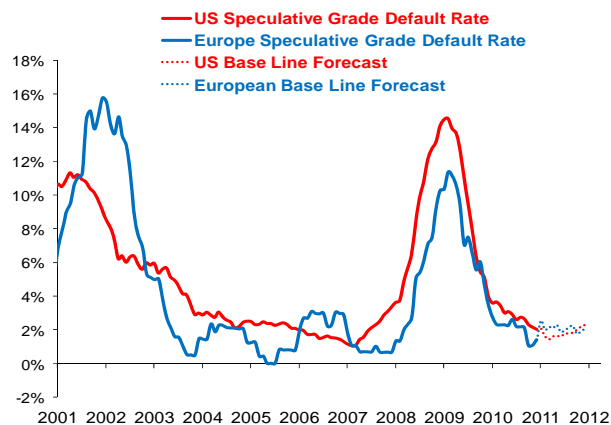
A lot of bad news is already priced into the high yield market, but unfortunately that is not a reason to assume credit spreads automatically tighten from here. EU policymakers are no closer to resolving the crisis of confidence affecting the continent's sovereign debt market and the Euro zone financial system remains on liquidity life support. A solution that involves closer fiscal co-ordination, either through the European Central Bank or other means, would no doubt provide a strong boost to risk sentiment and drive high yield credit spreads significantly tighter. However even if this does occur, the damage to the Euro zone economy has likely already been enough to cause a contraction in growth. Bank deleveraging will also continue to weigh on the economy as credit availability to firms and households shrinks, due to higher capital requirements for EU banks and funding problems. So even under a bullish scenario, we still see significant macro headwinds for the high yield market. We believe that the ECB will take needed actions to hold the EU financial system together, while the policymakers generate the political willingness to implement necessary and painful adjustments (we are talking quarters, maybe years).

BALANCE SHEET STRENGTH TO BE TESTED

A cautious approach on the part of company managers has helped to retain a reasonable degree of strength in corporate balance sheets, keeping the default rate for non-investment grade firms low. However, earnings will likely fall next year leading to a rise in average leverage. If earnings prove worse than estimated, ratings pressure will build on high yield companies and the default rate will rise. Signs of deterioration in creditworthiness are already showing and have led to greater dispersion among issuers and sectors.

Those companies with utility-like cash flows, healthy margins and a degree of pricing power should serve investors prioritising capital preservation well. We currently find companies like these in the media cable sector, where revenues are growing due to greater use of broadband and cable TV. Issuers from this sector have been some of the best performers in 2011 and we expect them to remain favourites of the high yield market in 2012. Beyond the cable sector, it is all about security selection as the diverse nature of the high yield market and increasing idiosyncratic risk combine to create a market of "winners" and "losers".

DEFAULT RATES LIKELY TO RISE



Source: FIL Limited, Moody's, 30/11/2011.

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IMMEDIATE REFINANCING NEEDS LOW

Market volatility provided a difficult year for the primary market, but fortunately loan and bond maturities were modest (€10 billion). The good news is that the refinancing needs for 2012 also look undemanding (€18 billion), but companies will continue to work towards reducing the refinancing hurdle of 2014-15. On top of this, EU banks' limited appetite for rolling over loans will continue, encouraging more companies to seek funding through the bond market. The move away from loans into high yield bonds has been a major trend in the last three years and it is expected to continue. As a consequence, we expect European domiciled companies to issue around €45 billion of new bonds in 2012, similar to the amount in 2011. We also expect more debut issuers to enter the market as part of the disintermediation of the banking sector. Given the tough macro backdrop these issuers are likely to have to accept a higher yield over established issuers, providing an attractive premium for investors with access to the primary market.

Low interest rates should continue to increase the investor base for yield, which will help to absorb the new supply. And if the economy avoids the recession and muddles along, it would foster strong demand for higher yielding product and good, but volatile, new-issuance conditions.

Default Rates

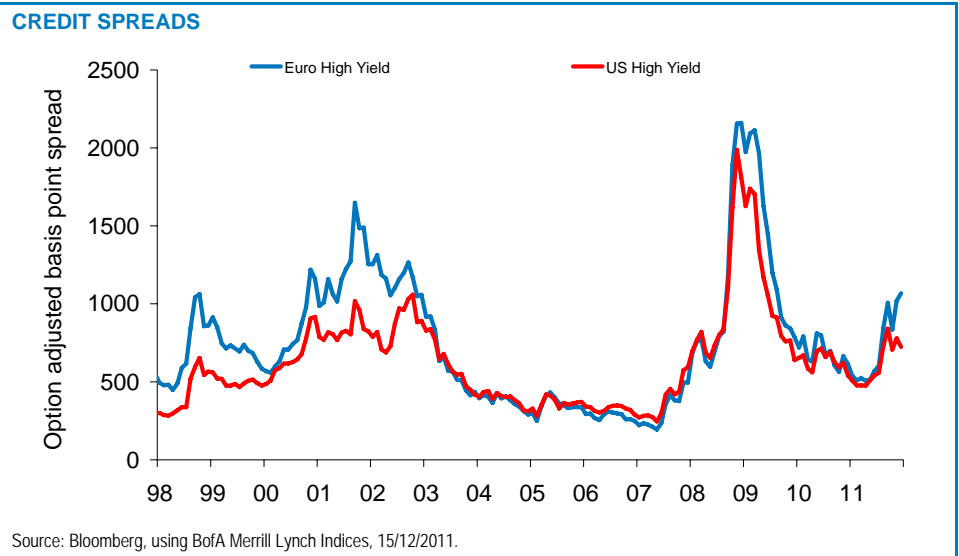
Current estimation of default rates in the European high Yield space is 4% if the actual current values of lending standards, credit quality and interest rates stay as they are. But, we are seeing tighter lending standards across Europe (currently at +16% according to the ECB survey). Banks deleveraging can bring have negative effects on High Yield credit. Firstly, corporates, being more reliant on bank funding, will have a much harder time rolling over their existing loans. Secondly, the High Yield space can become overcrowded as issuers are not able to secure bank financing. Thirdly, as the banks start to deleverage at the discount prices, this could create competition for investor's cash and issuers will have to start offering higher yields.

In case of further market volatility we are expecting further deterioration of lending standards (+20% or +30%) and another 50bp cut in the ECB target rate, as well as an increase in downgrade pressure. Consequently, the default rate would go up to 6%.

However, the High Yield balance sheets look in much better shape today, with leverage, coverage and liquidity metrics doing better now than in comparison to 2008 (10%-15% in prior recessionary period).

Spread forecast

Taking into consideration above mentioned conditions, we are expecting spreads to tighten to around 550bps.



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“Yields are now in double digits and I do think there’s some value, particularly in sectors like cable media and packaging. However, I expect default rates to increase from their current very low levels. This is partly due to the difficult macro environment, but it’s also going to be tough for leveraged companies to refinance with banks shrinking balance sheets and markets remaining volatile. On balance I’m neutral high yield, but stock selection will be important as I think dispersion levels will increase.”

Ian Spreadbury, Senior Portfolio Manager

THERE IS VALUE TO BE FOUND

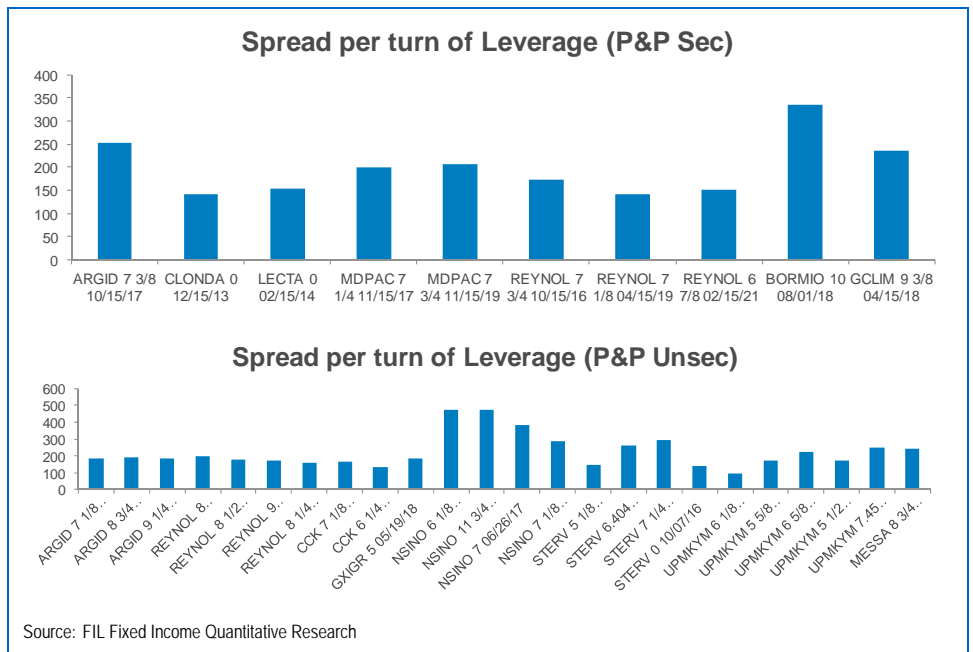
The high yield market also offers some value, but dispersion will be high, so good stock selection will be vital. Investors will look for ‘BB’ issuers that need low leverage and have good geographical and product diversification, in the primary market. The first time issuers will have to provide senior secured ranking notes and new issue premia to investors, while secondary markets have to exhibit value opportunities, especially with new financial regulations which could cause drawdown in liquidity within secondary markets.

CABLE AND PACKAGING REMAIN FAVOURED SECTORS

Credits that typically exhibit the above characteristics include cable media and packaging companies. These companies have strong cash-generation and profit growth in niche markets.

Cable assets kept stable during the last downturn. Yields are still attractive and downside risks are relatively limited. Deleveraging has been largely done and stable and growing earnings protects the downside. Most operators have defensive business models and healthy available liquidity. Strong market positions provide a defensive element while broadband and mobile cross selling opportunities are generating growth.

The packaging industry is mostly tied to the FMCG sector (food, beverages, pharma, cosmetics) which means it is a highly defensive industrial sector. Most packaging companies enter 2012 with the opportunity to modestly reduce leverage by year-end. Sector earnings, margins and cash flows were relatively resilient through 2008/9 and we expect to see the same in this down-cycle. Pricing on packaging products is set to improve as producers are keen to recover higher input costs this year. Higher consumption trends in emerging markets will assume a larger proportion of revenues in the years to come.



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