Finding Value in Europe

Q2 2021 Market Commentary

In an environment of low yields and compressed credit spreads, there is considerable value in dynamically allocating capital across different geographical markets. Each of our portfolios has a significant component of corporate bonds issued outside of Canada, which gives us a wider menu of investments. By hedging currency risk, we can benefit from this expanded opportunity set without introducing unwanted risk into our portfolios.

When you think about the European bond market, you may think of low or negative yields and assume limited opportunities. However, in recent quarters we have found some interesting areas of value in that market. In this article, we discuss some of the opportunities we are taking advantage of in our strategies.

1. Central bank differentiation: the European Central Bank (ECB) continues to support bonds

North American governments and central banks have effectively ended the bond-buying programs that were initiated to stabilize the capital markets during the initial lockdowns. In contrast, the ECB continues to support the European bond market in several ways, including through its corporate sector purchase program (CSPP).

An important distinction in the European corporate bond market is whether a particular bond is CSPP-eligible. If a bond is eligible, it is accompanied by an incremental buyer, resulting in those bonds trading at higher levels than other bonds in other markets. The ECB's continued buying of bonds and commitment to holding them helps act as a backstop for downside protection and driving spread compression.

2. Capitalizing on opportunities across currencies

Many global corporations issue bonds in multiple currencies, and often, these securities trade at quite different levels. The flexibility to invest outside of the CAD market means we can invest in companies we like in the most attractive format. For example, we recently identified an opportunity where the Euro-denominated bonds of a leading US telecom infrastructure company were trading at a significant discount to their USD counterparts even after adjusting for the cost of hedging the currency.

We saw the reverse occur with a different company in the same sector, where a leading European telecom infrastructure player issued in the USD market for the first time. Because of our team's knowledge of the business and the company's existing bonds and liquidity, we were comfortable participating in the new issue, which allowed us to see meaningful spread tightening after the launch of the new bonds.

3. Diversifying through differentiated exposures

From our many years of covering the European banking sector, we believe that the securities of the two largest Italian banks are priced very attractively, mainly in the USD market and the senior part of the banks' capital structures.

Italy has benefited from a few macroeconomic factors:

- The recovery from COVID-related shutdowns
- Ongoing support from the ECB/Eurozone (directly through liquidity support and indirectly through bond-buying programs)
- A more stable political environment
- The recent approval of Eurozone-wide sovereign debt issuance

In addition, the credit ratings on both the sovereign and banking sectors were recently upgraded as profitability, asset quality, and capital metrics have remained solid through the volatility.

Italian banks have had high non-performing loans in recent years because of many structural issues in the sector and the legal process around resolving these loans. However, the largest banks have also been among the most well-capitalized, strongly funded, and most profitable out of the systemically important European banking groups. They have also been able to capitalize on attractive consolidation opportunities in their domestic market and have integrated these franchises very well.

There is a significant yield pickup for investing in the two strongest banks, especially outside of their "home" market. However, we have concentrated our exposure to the senior part of the banks' capital structures which is also liquid and requires investment grade credit ratings to maintain strong balance sheets.

4. The generally slower "lockdown reopening" in Europe

This delayed reopening has allowed us to leverage our experience from North America's reopening to identify still-compelling opportunities in the European market and differentiate our portfolios further.

To take advantage of this opportunity in Europe, we have mainly focused on infrastructure companies, specifically toll roads and airports, as they have offered attractive asymmetric risk/return profiles. These have meaningful upside opportunities to pre-lockdown levels and strong downside protection because these assets are considered critical infrastructure with demonstrated government support. Much of this exposure is at the secured level of the capital structure, which also limits the volatility and ratings downside of the investment in the near term, in our view. Ratings agencies have also recognized the resiliency of their operations and the downside protection offered to hold or even upgrade ratings.

We believe our ability to invest in securities outside of the Canadian market is a key advantage at this point in the credit cycle. Should you wish to discuss further the opportunities that we are seeing or how we are capturing them, please reach out to a member of the Client Portfolio Management team.

Important Information

Unless indicated otherwise, commentary, returns and portfolio data is presented as of June 30th, 2021.

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