Halbis
HSBC Global Asset Management

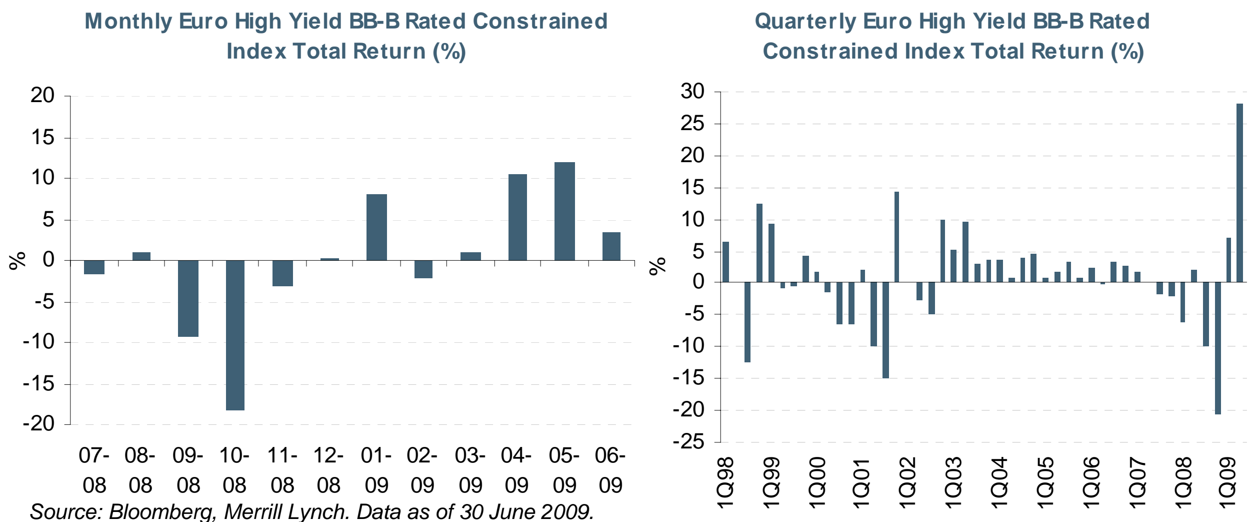
From The Desk – Euro High Yield Bond 2nd quarter 2009 Review

Paris, July 2009

Euro High Yield Market Review

Performance Update

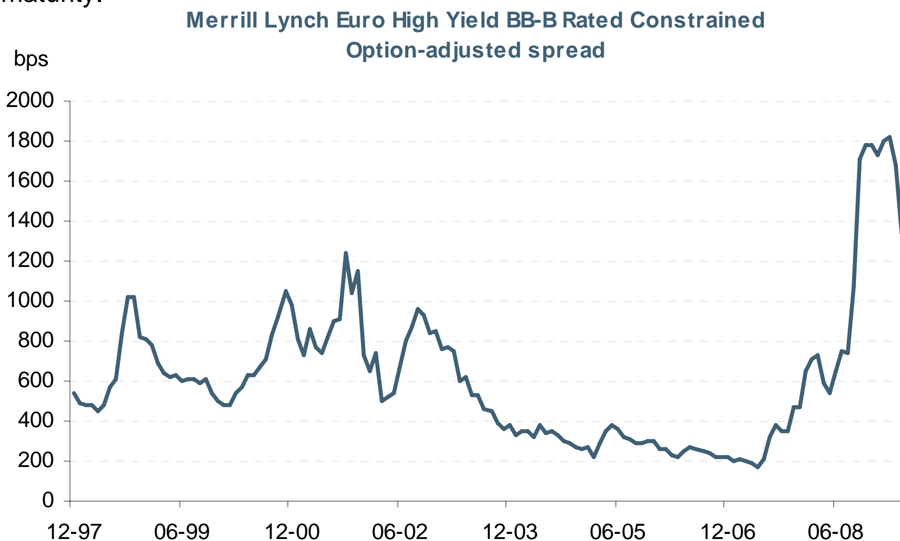
The Euro High Yield market staged an extremely strong rally during the second quarter. The overall performance for the quarter was +28%. This follows an already respectable first quarter and puts the year-to-date performance at an impressive +37%.



Source: Bloomberg, Merrill Lynch. Data as of 30 June 2009.

How to explain such a performance in the midst of the worst recession since the second world war?

It is important to stress that we began this quarter at an historical level: on 03/31/09 the average spread of the market was 1822bps, the highest level ever seen, corresponding to a 22% average yield-to-maturity.



Source: Bloomberg, Merrill Lynch. Data as of 30 June 2009.

The performance shown refers to the past and should not be seen as an indication of future performance.

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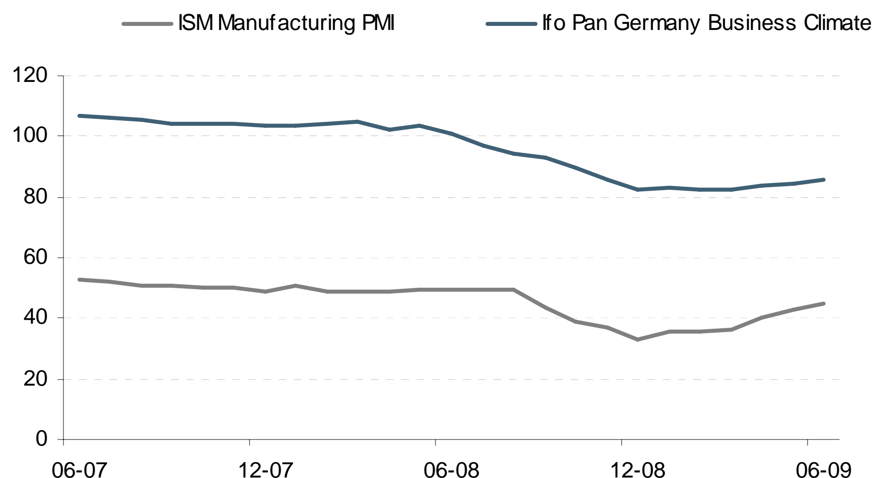
This extreme level was the reflection of three concerns on the part of investors:

- A dire economic situation: at the end of March, the global economy looked to be in a free fall. Hard data (GDP, industrial production, trade data, etc) were disastrous while forward-looking indicators such as confidence surveys showed no rebound.
- Financial markets in a deadlock: in spite of widespread government intervention, financial markets continued to malfunction. Particularly worrying for High Yield issuers was the impossibility to get access to funding through bank loans or raising new issues in the market.
- Extremely high risk aversion on the part of investors: in spite of yields above 20%, the lack of market visibility caused investors to remain extremely risk averse.

The second quarter brought significant improvement on these three points:

- Forward-looking indicators bottomed-out. These indicators are sufficiently reliable that most economists now expect the end of the recession in the US in the third quarter of 2009 and in the Eurozone at the beginning of 2010. This is a massive improvement compared to the complete lack of visibility that prevailed at the end of March.



Source: Bloomberg. Data as of 30 June 2009.

- Financial market conditions improved markedly: this was most seen in monetary markets where central banks were successful in bringing short-term rates to near-zero levels, a sign that concerns about the liquidity situation in the financial system have largely disappeared. An other very encouraging sign was the record amount of new bond issues on credit markets around the globe. The improvement was so spectacular that even some European High Yield issuers were able to issue new bonds, something that had become close to impossible during the last 18 months.
- Consequently, investors became more inclined to increase their risk exposure. The extremely low levels of short-term rates was an other factor pushing them towards risky assets. And it looks like credit was the asset class of choice for most of them when they decided to implement this strategy: virtually all credit products registered strong inflows during the quarter.

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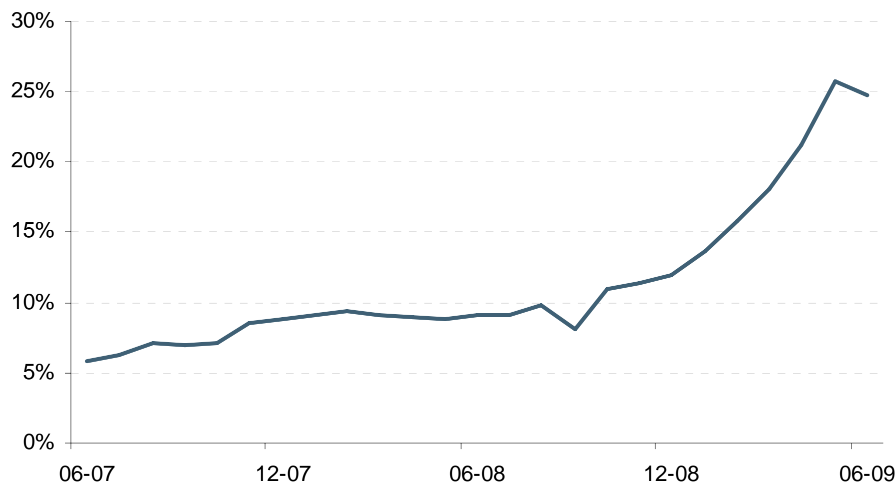
Market Composition Update

The highlight of the quarter in terms of market composition was the continued increased weight of the financial sector. During the quarter financials became the largest sector in the market, before the capital goods sector. This is obviously a consequence of the financial crisis as credit ratings of most financial institutions have come under significant downward pressure. The vast majority of this financial segment of the market is composed of subordinated debt issued by some of the most troubled banks and insurance companies, such as RBS, Lloyds/HBOS, Dexia and KBC.

Weight of the financial sector in the ML Euro High Yield BB-B Constrained Index



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HSBC GIF Euro High Yield Bond Review

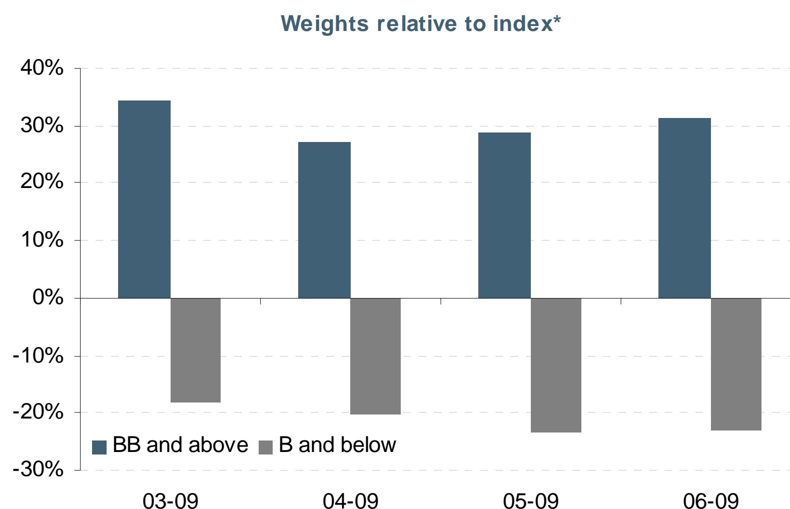
Strategy

During the quarter, the fund's strategy continued to be underpinned by two convictions:

- The Euro High Yield market is attractive because risk premiums are extremely high. Historically these periods of high risk premiums have been followed by periods of strong performance.
- The higher ratings (BB and above) offer the most attractive risk-adjusted returns because the room for maneuver of the lower rated issuers (B and below) is extremely limited. Whether these speculative issuers default or not will largely depend on the timing and extent of the economic recovery, something that is very difficult to judge at the current juncture.

These convictions were reflected in the fund through the following strategies:

- Maintain a high investment ratio in order to remain sufficiently exposed to the High Yield market. Over the course of the quarter the investment ratio remained in the 103%-116% range. The fund was therefore slightly leveraged. This was achieved through the use of Credit Default Swaps (CDS): we sold protection on some issuers and indices to increase our exposure to the bond market.
- Maintain an average quality higher than the benchmark: we consistently underweight the B category while overweighting the higher ratings. This strategy was actually reinforced during the quarter as we took advantage of the rally to exit some positions we had become uncomfortable with from a fundamental credit quality perspective.



HSBC GIF Euro High Yield Bond fund, source Halbis, data as at 30 June 2009.
**Index of comparison is Merrill Lynch High Yield Constrained Index RI (BB-B), for illustrative purposes only as the Merrill Lynch High Yield Constrained Index RI (BB-B) is not the official fund's benchmark - This does not constitute any kind of commitment for Halbis.*

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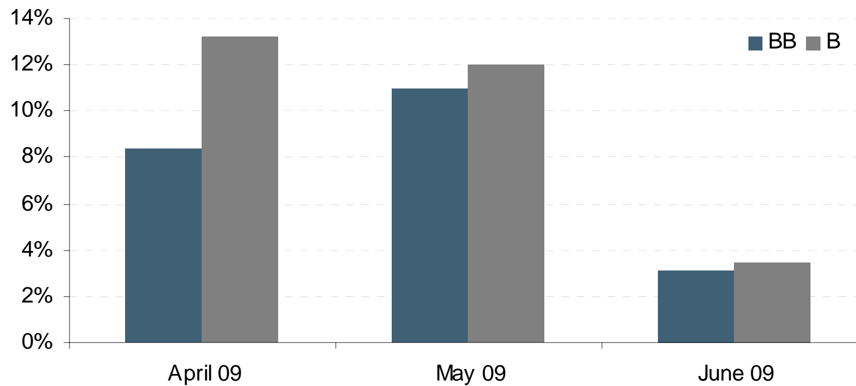
Performance

This positioning was not sufficient to keep pace with the benchmark as the lower ratings clearly outperformed the higher ratings: the fund performance was +24% over the quarter, compared to +28% for the Merrill Lynch High Yield Constrained Index RI (BB-B)*.

Euro High Yield: Monthly Performances by Rating



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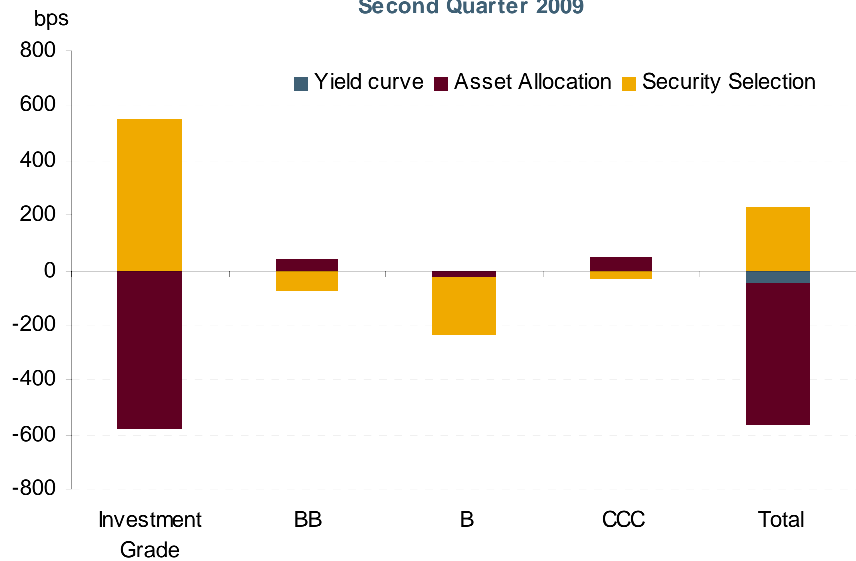
This relative performance over the period can be decomposed as follows:

HSBC GIF Euro High Yield Bond Relative Performance Attribution - Second Quarter 2009



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The following comments can be made:

- The asset allocation detracted from performance. As explained above this came from an overweight on Investment Grade bonds during a period were High Yield outperformed Investment Grade by a wide margin.
- The security selection was a positive contributor to performance. This was especially true in the Investment Grade segment were it almost compensated the negative asset allocation. This is simply because the Investment Grade bonds that were selected in the portfolio were much more risky than the average of the Investment Grade market: they were either subordinated financial debt or “crossover” bonds (i.e. close to the Investment Grade/High Yield border). In both cases their risk profile was much closer to High Yield than Investment Grade. This was also true for their performance over the period. However, the security selection in the B segment was negative. The reason is that our B-rated investments were relatively defensive. For example a significant part of them belonged to low-cyclical sectors such as telecommunications. As a result they did not perform as strongly as the cyclical B-rated bonds.

Market outlook

General market view

Fundamental Credit Quality

Unsurprisingly the economic environment has already begun to have an effect on default statistics: the trailing twelve months default rate on the Global High Yield market has reached 10.1% at the end of June. This is to be compared to an average of 4.4% over the last 30 years.

It is worth mentioning that default trajectories in the US and in Europe have been quite different so far: over the last twelve months the default rate in the US has been 11.0% but only 5.6% in Europe. Reasons behind this difference are probably the lower average quality of the US High Yield market (in particular the significantly higher share of the CCC category) and the fact that the recession began earlier in the US (December 2007).

Going forward, the baseline scenario of Moody’s is that the Global High Yield default rate will continue to increase to a peak of 12.8% in November 2009 before decreasing rapidly to 6% in June 2010. Interestingly enough, Moody’s believes that at 11.0%, the US default rate is already close to its peak while the European default rate is expected to continue to increase very sharply, peaking to 15% in December 2009. Moreover Moody’s expects the US default rate to decrease rapidly after its peak while the decrease of the European default rate would be much more progressive: in June 2010 the European default rate would still be at 12.5% versus only 5.0% in the US.

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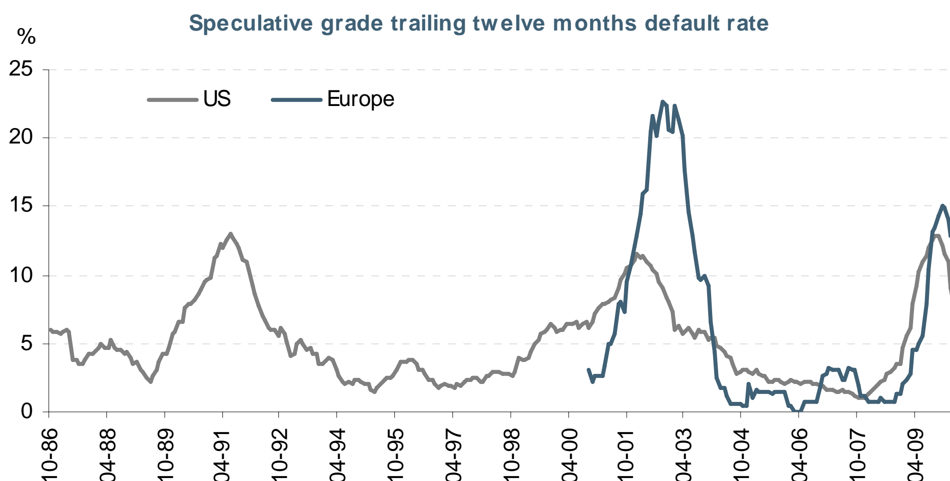

Source: Moody's – Data as at 30 June 2009.

It is worth mentioning that Moody's default rate forecasts are based on forecasts regarding the unemployment rate and spread levels. We therefore suspect that the higher default rate in Europe may simply be a reflection of the higher average spread level in Europe: as at 06/30/09 the average spread level for BB was 154bps higher in Europe and the average spread level for B was 753bps higher in Europe. We think that this is a consequence of the narrower investor base in Europe that has resulted in a bigger market dislocation during the credit crisis. What is more important in our view is that the average credit quality in Europe remains higher than in the US: in particular the highly speculative CCC category only represents 13% of the European market but 25% of the US market. Consequently, we would not be surprised to see the European default rate remaining lower than the US default rate in the next twelve months.

Market valuation

As at 06/30/09 the average spread on the Euro High Yield market was 1449bps. Spreads and default rate are related by the following approximate formula:

Spread ≈ implied annual default probability × (1-recovery rate)

Historically the average recovery rate on High Yield bonds has oscillated in the 20% to 60% range. The 20% rate is associated with crisis periods, when there is a large number of defaults and market values for assets are generally low. Taking into account the extreme nature of the current crisis, as well as the presence in the Euro High Yield market of financial subordinated debt (which would recover very little in case of default) we use 10% as our assumption for the recovery rate. We then find that the implied annual default probability as at 06/30/09 was 16%. The following table shows the cumulated default rates corresponding to this annual rate:

	Cumulated default rate %
1 year	16
2 years	30
3 years	41
4 years	50
5 years	58

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To determine whether current market valuations are attractive we compare the implied 5 years cumulated default rate to historical experience during stressed period and to current Moody's forecasts:

	Worst cumulated 5 years default rate
Great Depression (US)	around 45%
1990-1991 recession (US)	around 35%
2001-2002 recession (US)	around 35%
2001-2002 recession (Europe)	around 42%
Current recession (US, baseline Moody's expectation)	around 25%
Current recession (Europe, baseline Moody's expectation)	around 25%

We would have the following comments:

- Moody's expectations appear optimistic: given that the economic situation can be described as worse than in 1990-1991 and 2001-2002, but better than the Great Depression, it would be logical to see the cumulated 5 year default rate peaking between 35% and 45%.
- With an implied cumulated 5 year default rate of 58%, the risk premium offered by the market currently seems adequate, especially given that we arrived at 58% using a very cautious 10% average recovery rate and that the current average credit quality of the Euro high Yield market is relatively high (low percentage of CCC rated credits).

That is why we find the market attractive and we maintain a high investment ratio (109% as at 06/30/09).

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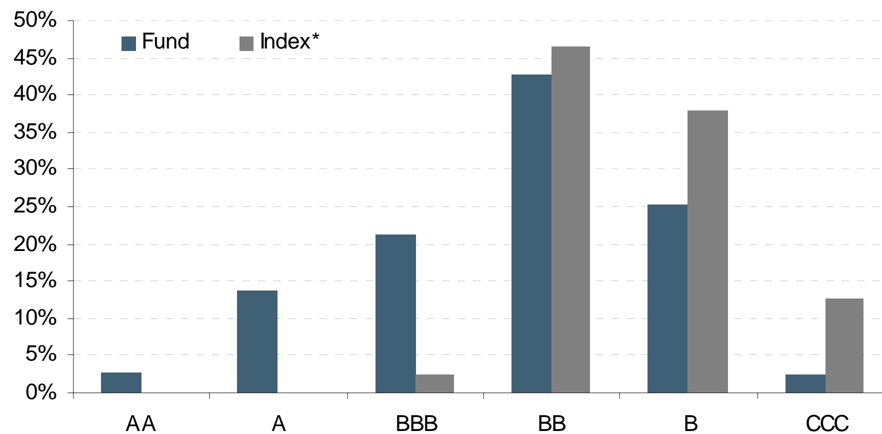
Ratings, sectors and issuer selection considerations

Ratings

We maintain our preference for the higher ratings. Our view is that it is not currently possible to assess the timing and the extent of the economic recovery. Consequently, we seek issuers that can survive if the recovery is more muted or comes later than expected. Such issuers are naturally found amongst the higher ratings because the lower rated issuers generally have very leveraged balance sheets that can not withstand severe economic conditions for a long time.

Fund and Benchmark Rating Breakdown



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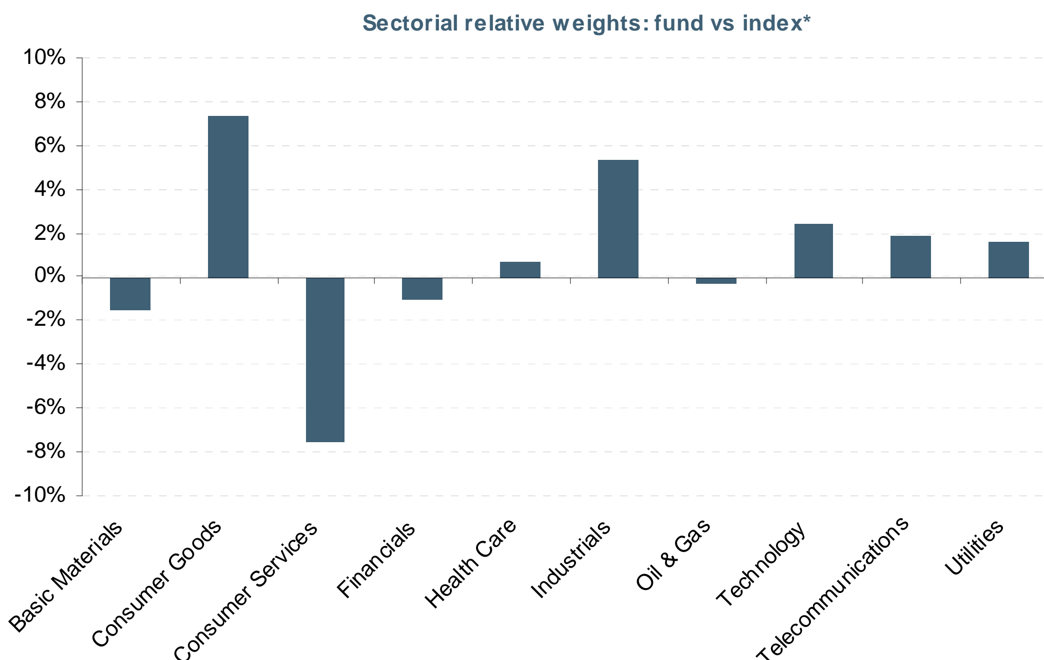
Sectors



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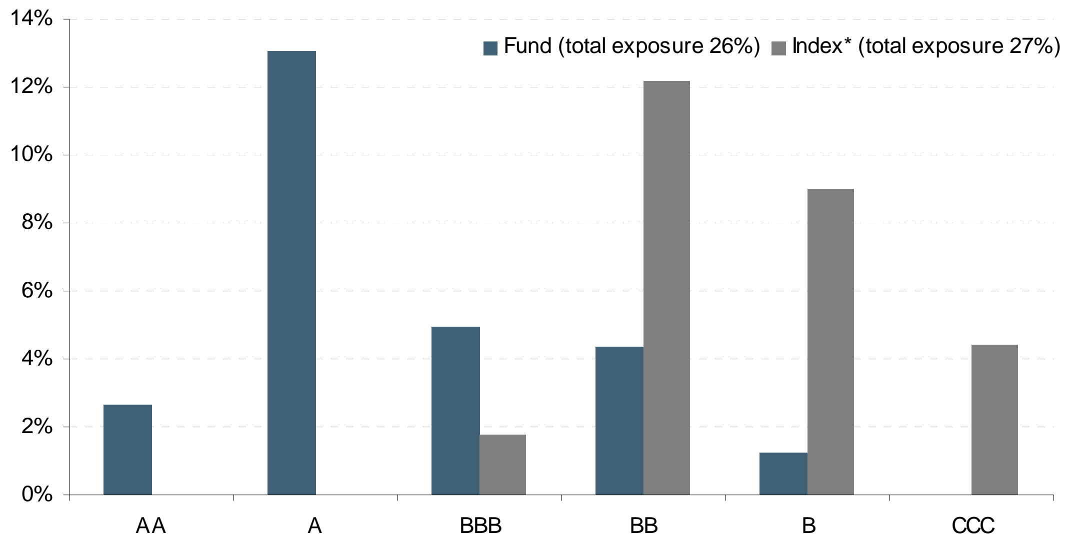
Our main sectorial bets are the following:

- We overweight the consumer goods sector. This comes largely from an overweight of the automobile industry, where we have positions on Fiat (BB), Renault (BB), Volvo (BBB), Volkswagen (BBB), Michelin subordinated (BB) and Valeo (BB). This overweight is underpinned by the fact that, although this industry is experiencing a severe environment, these issuers benefit from the scale and diversity of their operations, their competitive positioning and their strategic importance for their respective countries. These are qualities that are seldom found amongst usual High Yield issuers.
- We underweight the consumer services sector. The gaming, transportation and car rental industries belong to this sector. All of them have been amongst the main casualties to the current crisis. Moreover most of these issuers are small and privately owned. Consequently, they can expect little support if necessary.

Focus on the financial sector

As mentioned above, the financial sector has now become the largest sector within the Euro High Yield market with a weight of 27% in our benchmark. We currently have a slightly underweight position on this sector, but the most important point is that our bond picking is extremely different from the benchmark, and much more defensive.



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The reason is that most issuers in our portfolio belong to the group of financial institutions that have resisted relatively well to the current crisis. Examples include BNP, Crédit Agricole, HSBC and Intesa SanPaolo. In spite of being issued by relatively strong institutions, the subordinated bonds of these institutions still offer what we consider to be quite attractive yields, for example 10% to 20% for Tier 1 bonds (the most subordinated ones), assuming the issuers call them at the first opportunity.

By contrast the benchmark mostly contains subordinated bonds issued by weaker institutions. Examples include RBS and Lloyds/HBOS. Yields offered by these bonds are higher but so are their risks. A particular source of risk is the partial nationalization of these banks as governments may decide that bail-out capital should not be used for the benefit of subordinated bondholders.

Issuer selection considerations

The last twelve months have left little room for issuer selection : the market collapse affected all issuers and the recent rebound has also benefited the vast majority of issuers as the default rate has remained rather contained until now in Europe. We think that in the next few months the sharp increase of the default rate will bring issuer selection to the forefront. Our strategy in this regard is to benefit from a degree of resilience of the different issuers in case of a disappointing economic recovery.

This resilience generally comes from:

- Defensive sectors such as food, beverage, telecoms, utilities and healthcare, or,

- An above average capacity to access external sources of funding in case of necessity. This can come from issuing equity, from selling bonds or loans or from selling assets. Our experience is that large publicly listed corporations, with diverse operations and strategic importance are much more able to access these sources of funding if needed. That is why we favor them in our portfolio. Examples include auto manufacturers (see above) and also the subordinated bonds from Bayer, Linde, Siemens and Vinci.

Main portfolio indicators as at 06/30/09

	HSBC GIF Euro High Yield Bond	Merrill Lynch High Yield Constrained Index RI (BB-B)*	Comment
Number of issuers	90	118	
Average rating	BB+/BB	BB-/B+	Significantly higher credit quality in the fund (see rating breakdown)
Yield to maturity	10.8%	16.1%	Consequence of the higher credit quality
Average spread (vs govt. bonds)	823bps	1283bps	Consequence of the higher credit quality
Credit duration	4.5	3.5	Increase exposure to the market by favoring long-dated bonds
Investment ratio	109%	100%	Increase exposure to the market by selling protection on the CDS market

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