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EUROPEAN HIGH YIELD: THE 'SWEET SPOT' OF FIXED INCOME?

Philippe Berthelot
CIO Credit & Money Market

THE EUROPEAN MARKET STILL HAS POTENTIAL

At this end of 2024, the European High Yield market is once again outperforming Investment Grade. With ca. **+8% year-to-date performance. With an actuarial yield of 5.5%, relatively stable default rates and supportive technical factors,** European High Yield should remain the 'sweet spot' of the European bond market in 2025.

We think that the European High Yield market should continue to be driven by the trajectory of bond yields in Europe. As money market rates are falling, there could be a crowding-out effect towards the credit asset class, particularly in the European High Yield market. As a corollary, the segments of subordinated debt, in particular **AT1 on the financial part** as well as **hybrid bonds on the corporate part**, could benefit from these reallocations.

The credit spreads of the asset class seem rather cheap when compared to the US High Yield market. But they are rather tight compared to their 5-year historical average. Despite a spread tightening in recent months, the yields offered by the asset class **remain historically high and should continue to attract inflows** (11 months of positive inflows over the last 12 months), supporting the asset class. Even with a 50 bp spread widening, European high yield performance should be above the Investment grad market. To note that some issuers in the European High Yield market have credit spreads that already reflect very strong economic downgrades, as is the case for the automotive sector for example.

Finally, in a less likely scenario that would see trade war or geopolitical themes improve, high yield risk would be the main beneficiary in the European bond market, and should continue to outperform the bond asset class.

Corinne Gaborieau
Corporate Credit Analyst

HIGH YIELD ISSUERS: FUNDAMENTALS RESILIENCE

Earnings from European high yield groups have **demonstrated resilience**, meeting expectations until the second half of the year. However, this period was marked by sudden profit warnings, especially in the auto sector, highlighting a rapid shift in demand dynamics. These downward revisions followed a period of strong results driven by post-pandemic recovery and companies' adeptness at managing rising commodity and energy costs amidst inflation.

Looking forward, declining inflation and easing monetary policies are expected to offer some support for operating performance, even within a challenging economic landscape. Nonetheless, **global muted growth prospects and geopolitical risks** may hinder significant improvements in performance across sectors. Sectors tied to discretionary spending, facing Chinese competition, and within the European automobile industry are anticipated to be most affected, though their fundamental business models should remain viable.

In recent years, many companies have successfully extended their debt maturity profiles, often securing more favorable terms due to improved financial health including leverage reduction. The number of distressed issuers has decreased throughout 2024, with few below-par debt restructurings. Consequently, default rates for high yield groups are expected to remain well below historical averages in 2025.

Additionally, non-financial disclosures have improved significantly, with private bond issuers in the high yield sector increasingly defining their ESG strategies and setting decarbonization goals, thereby enhancing transparency for investors.

Julien Petit
Credit Portfolio manager

A REALITY NUANCED BY SEGMENT

This end of 2024 still offers pockets of interesting performance in the European high yield debt market.

While some market indicators have fairly tight valuation levels, they hide in a much more nuanced reality. There is a wide dispersion in terms of valuation within the different segments, whether BBs, B's, AT1 's, or hybrids, which are the core asset classes of European High Yield.

Industrial and/or technological disruption in some sectors has created many investment opportunities. Exposure to these bonds/sub sectors will drive alpha generation in the coming months.

In parallel, there is a multitude of 'credit stories,' at the issuer level that allow, **based on rigorous and robust selection**, to extract attractive spread levels.

On high beta debt, especially hybrids and AT1's, we are structurally 'long,' in a general context of falling rates. We are working on different scenarios to build and manage the allocation. For example, **on AT1s**, one of the main themes, remains concentration in the European banking sector, and core country risk with its repricing potential.

We anticipate a European High Yield context which should therefore remain positive, supported in particular by strong technical factors. Some issuers offer opportunities that are still attractive in terms of risk/return profile, particularly in the subordinated segment.

Sector selection and stock picking will again be one of the themes for 2025.

Document for professional investors. Written on 06/12/2024.

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