Five themes shaping Euro corporate bonds

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Euro Corporate Bond

Attractive yields and positive technicals support the asset class as the economy slows.

- Yields are attractive from both an absolute perspective and a relative perspective to government bonds.
- Technicals are providing a positive tailwind: The asset class has seen robust demand against lower net issuance.
- Against a backdrop of the slowing eurozone economy, security selection remains imperative.

The European investment-grade corporate bond market continues to look attractive given that yields are around their highest levels in over a decade. Technicals and fundamentals are also supportive, but with the eurozone economy continuing to slow, security selection is key.

Below, we delve into five themes currently shaping activity and performance in the European investment-grade corporate bond space.

1. Yields remain attractive

The European investment-grade corporate bond market continues to offer investors a compelling income-generating opportunity, particularly to those investing with a long-term horizon. Indeed, the average yield on offer in the asset class is 4.45% —the highest level since January 2012. This is not only competitive in absolute terms, but also in relative terms as it offers a yield pickup over traditional government bonds.

2. Positive technical picture

Technicals should provide a positive tailwind for euro investment-grade corporate bonds. The asset class has seen a return of inflows, a trend we expect to continue given the high all-in yield available for investors. We expect issuance volumes to be manageable because the funding needs of investment-grade companies are currently light as mergers and acquisitions deals are languishing at a decade low. Furthermore, corporate cash levels are broadly high, reducing the need for companies to come to the primary market to raise finance. Overall, we believe that the sharp rise in rates is net bullish for corporate bonds as the likely positive impact on demand should outweigh the risks relating to higher potential funding costs and tighter monetary policy.

3. Supportive fundamentals are easing slightly, but from a strong base

The economic downturn is starting to weigh on corporate profit margins. Although this is leading to a slight deterioration in corporate fundamentals, most companies are entering this slowdown from a position of strength. Overall, investment-grade companies are underpinned by solid fundamentals—leverage levels are low, and interest coverage ratios are still comfortably above historical averages. This is supportive and gives companies a greater buffer to navigate this period of weak economic growth.

4. European Central Bank has likely finished hiking

The likely end of the European Central Bank's (ECB) tightening cycle should give markets some comfort, particularly if it helps to ease interest rate volatility. At the latest policy meeting held in October, the ECB held interest rates steady after 10 consecutive hikes. We believe that the next phase of the monetary policy cycle is now underway and there will be interest rate cuts at some point in 2024 given the weak economy. This could potentially lead to some capital gains for European investment-grade corporate bonds. However, we are mindful of the ECB's ongoing quantitative tightening program and do not rule out volatility from this, especially if the process is accelerated.

5. Security selection imperative as growth weakens

In an environment where growth is weakening, skilled security selection and sector allocation, informed by in-depth fundamental research, is vital. At present, we are cautious on the outlook for real estate, a sector vulnerable to increased funding costs and where we believe there is an increased 'fallen angel' risk. Fundamentals are weak, particularly in the office subsector, amid tighter credit conditions and limited deleveraging opportunities.

By contrast, we like the European financials sector, which is supported by appealing valuations and broadly resilient fundamentals. In particular, we like Icelandic banks due to their sound capital and liquidity positions and select Spanish banks, which benefit from strong profit margins. We also find Central and Eastern European banks attractive. Many of these banks are linked to Western European financial institutions yet offer an attractive spread both to their developed market peers and to the sovereign debt of countries they are located in. Not all areas of the financials sector are attractive, however. We are wary of banks with particularly high exposures to commercial real estate, for example.

Overall, we believe the compelling case for the asset class remains in place, with positive technicals and the highest available yields in more than a decade. The likely end of the ECB's hiking cycle is also supportive, especially if it leads to interest rate volatility easing. Although there are signs of fundamentals easing, this is from a strong base, which should help provide some protection as eurozone growth weakens.

[1] Yield to maturity of the Bloomberg Euro Aggregate – Corporate Bond Index as of October 31, 2023.

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