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Three reasons European corporate bonds remain attractive

From the Field
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Key Insights

- European investment-grade corporate bonds offer investors a combination of attractive income and high-quality duration.
- Technicals should remain a positive tailwind as demand for the asset class is likely to continue, while net issuance is expected to be manageable.
- The macro backdrop is weak, however, underscoring the importance of fundamental research to power security selection.

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The strong run of European investment-grade corporate bonds in 2023 has left investors asking if they have missed the boat to allocate. The answer is a firm no, in our view. All-in yields available in the asset class are high, which is attractive for investors seeking income and high-quality duration. Technicals and fundamentals also paint a supportive picture. But the eurozone economy is weak, underscoring the importance of fundamental research to power security selection.

In this article, we take a look at the three key areas that underpin our constructive view of the asset class.

1. Valuations—Attractive all-in yields

Despite the recent strong rally in credit spreads—they remain above long-term averages and materially higher than the post-pandemic lows of 2021. From a yield perspective, the all-in yield available remains high and continues to offer investors an attractive income-generating opportunity. At the end of December 2023, the average yield in European investment-grade corporate bonds was around 3.56%—which is well above the average level of 1.41% observed in the last decade.[1] This is competitive not only in absolute terms, but also in relative terms as it offers a yield pickup over traditional government bonds.

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[1] As of December 31, 2023. Yield to worst of the Bloomberg Euro Aggregate—Corporate Bond Index. Source: Bloomberg Finance L.P.

Three factors supporting European corporate bonds

(Fig. 1) Constructive view underpinned by valuations, fundamentals, and technicals

Attractive Valuations

— High all-in yield available

— Yield is competitive in absolute terms and relative to government bonds

Healthy Fundamentals

— Leverage levels are low

— Interest coverage ratios above historical averages

Positive Technicals

— Inflows to asset class expected to continue

— Net issuance expected to be manageable

As of March 2024.
For illustrative purposes only. This is not intended to be investment advice or a recommendation to take any particular investment action.
Source: T. Rowe Price analysis.

2. Fundamentals—Remain solid overall

The weak economic environment is leading to a slight deterioration in corporate fundamentals, but this easing is from a position of strength. Overall, investment-grade companies are underpinned by solid fundamentals. Leverage levels are low and interest coverage ratios—which have understandably declined from the historic highs of the negative interest rate era—are still comfortably above historical averages. This is supportive and gives companies a buffer to navigate this period of economic uncertainty.

Furthermore, the European Central Bank has finished hiking and will move into easing at some point in 2024 given the weak eurozone economy. This could help stabilize interest rate volatility and potentially even lead to some capital gains for European investment-grade corporate bonds.

3. Technicals—Positive tailwinds continue

Technicals should continue to provide a positive tailwind for European investment-grade corporate bonds.

The asset class has seen a return of strong inflows, a trend we expect to continue given the high all-in yield available for investors. The supply-side dynamics are also expected to be supportive this year. Given the modest funding needs of investment-grade companies for capex and mergers and acquisitions, new issuance volumes are expected to be manageable. Furthermore, corporate cash levels are broadly high, reducing the need for companies to come to the primary market to raise finance.

Importance of security selection

While these areas are clearly supportive for the asset class, there are risks that need to be carefully navigated this year. The eurozone economy is weak. This, combined with sticky inflation and ongoing geopolitical risks, underscores the importance of choosing an approach that is risk aware and prioritizes research. Specifically, there are three key attributes that investors should look for when choosing a manager for European corporate bonds.

- **Regular outperformance versus benchmark:** The ability to deliver regular outperformance over the benchmark in a range of different market environments. Outperforming when markets are rising is typically "easier," but mitigating loss when markets are falling is what differentiates managers and approaches.
- **Downside risk management:** A focus on managing downside risks, particularly at times of market stress and rapid credit spread widening. For example, using credit derivatives as a defensive tool could help to cushion a portfolio's performance during periods of market turbulence.
- **High liquidity profile:** A bias for high-quality issuers and liquid securities. This should help a manager be dynamic and adapt to changes in the market environment.

Overall, we believe the compelling case for the asset class remains in place, with resilient fundamentals, positive technicals, and yields that are not far off a decade high. But the tricky macroeconomic backdrop demands skilled security selection. This should suit an approach that prioritizes bottom-up research and the rigorous management of risks at both an individual position level and the overall portfolio level.

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