

Three reasons European corporate bonds remain attractive

From the Field
March 2024

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.



David Stanley
Portfolio Manager, Euro
Corporate Bond Strategy

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.

“...the all-in yield available remains high and continues to offer investors an attractive income-generating opportunity.”

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.

INVEST WITH CONFIDENCE™

T. Rowe Price identifies and actively invests in opportunities to help people thrive in an evolving world, bringing our dynamic perspective and meaningful partnership to clients so they can feel more confident.

Important Information

This material is being furnished for general informational and/or marketing purposes only. The material does not constitute or undertake to give advice of any nature, including fiduciary investment advice, nor is it intended to serve as the primary basis for an investment decision. Prospective investors are recommended to seek independent legal, financial and tax advice before making any investment decision. T. Rowe Price group of companies including T. Rowe Price Associates, Inc. and/or its affiliates receive revenue from T. Rowe Price investment products and services.

Past performance is not a reliable indicator of future performance. The value of an investment and any income from it can go down as well as up. Investors may get back less than the amount invested.

The material does not constitute a distribution, an offer, an invitation, a personal or general recommendation or solicitation to sell or buy any securities in any jurisdiction or to conduct any particular investment activity. The material has not been reviewed by any regulatory authority in any jurisdiction. Information and opinions presented have been obtained or derived from sources believed to be reliable and current; however, we cannot guarantee the sources' accuracy or completeness. There is no guarantee that any forecasts made will come to pass. The views contained herein are as of the date written and are subject to change without notice; these views may differ from those of other T. Rowe Price group companies and/or associates. Under no circumstances should the material, in whole or in part, be copied or redistributed without consent from T. Rowe Price.

The material is not intended for use by persons in jurisdictions which prohibit or restrict the distribution of the material and in certain countries the material is provided upon specific request.

It is not intended for distribution to retail investors in any jurisdiction.

Colombia, Chile, Mexico, Perú, Uruguay—This material is prepared by T. Rowe Price International Ltd - Warwick Court, 5 Paternoster Square, London, EC4M 7DX which is authorised and regulated by the UK Financial Conduct Authority - and issued and distributed by locally authorized distributors only. For professional investors only.

DIFC—Issued in the Dubai International Financial Centre by T. Rowe Price International Ltd which is regulated by the Dubai Financial Services Authority as a Representative Office. For Professional Clients only.

EEA—Unless indicated otherwise this material is issued and approved by T. Rowe Price (Luxembourg) Management S.à r.l. 35 Boulevard du Prince Henri L-1724 Luxembourg which is authorised and regulated by the Luxembourg Commission de Surveillance du Secteur Financier. For Professional Clients only.

South Africa—Issued in South Africa by T. Rowe Price International Ltd (TRPIL), Warwick Court, 5 Paternoster Square, London EC4M 7DX, is an authorised financial services provider under the Financial Advisory and Intermediary Services Act, 2002 (Financial Services Provider (FSP) Licence Number 31935), authorised to provide "intermediary services" to South African Investors. TRPIL's Complaint Handling Procedures are available to clients upon request. The Financial Advisory and Intermediary Services Act Ombud in South Africa deals with complaints from clients against FSPs in relation to the specific services rendered by FSPs. The contact details are noted below: Telephone: +27 12 762 5000, Web: www.faisombud.co.za, Email: info@faisombud.co.za

Switzerland—Issued in Switzerland by T. Rowe Price (Switzerland) GmbH, Talstrasse 65, 6th Floor, 8001 Zurich, Switzerland. For Qualified Investors only.

UK—This material is issued and approved by T. Rowe Price International Ltd, Warwick Court, 5 Paternoster Square, London EC4M 7DX which is authorised and regulated by the UK Financial Conduct Authority. For Professional Clients only.

© 2024 T. Rowe Price. All Rights Reserved.