RBC Global Asset Management

Set to outperform? Why European corporates look attractive vs the US

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"We believe that these elevated yields represent an opportunity, as there is a good chance that European corporates will outperform going forward."

We are seeing value in European investment grade corporates relative to their US counterparts, says Tom Moulds.

From a valuation perspective, European corporates now look pretty attractive. The spread to government bonds is trading around 25 to 30 basis points wider than corporates in the US[1], and at times over the past year, the gap has been even bigger than that.

This is all the more noteworthy because, historically, the relationship would usually be the other way around. You would typically expect European corporates to trade tighter than those in the US, not least because the average duration across the US corporate bond market is a full two years longer with a similar average credit rating. We believe that these elevated yields represent an opportunity, as there is a good chance that European corporates will outperform going forward.

What pushed European spreads up?

To understand why European spreads may improve, we first need to understand what drove them up in the first place. There are three main reasons.

The first and most powerful was the start of the Russia-Ukraine war. European bonds underperformed materially in 2022 due to Europe's proximity to the region and the perceived impact on European companies. Sectors like industrials and utilities, were very exposed to volatile energy prices and were big drivers of underperformance. For example, German chemical companies use substantial amounts of energy.

That created the initial widening between European and US spreads, but a second driver came into play just as the energy situation started improving. This was an escalation in financial bond supply. 2022 was one of the worst years on record for fixed income returns, and as a result, there had not been a lot of primary market activity, particularly from issuers such as financials. But as conditions started to improve towards the end of the year, European banks needed to fulfil their regulatory capital buffers. This meant issuing senior non-preferred debt, and the resulting influx of financial bonds caused the market to keep repricing.

Moving into 2023, the third curveball was volatility in the banking sector. It began in March with the collapse of Silicon Valley Bank, which initially drew markets' attention to US financial fixed income. However, later that same month, Credit Suisse had to be rescued from collapse by UBS, and the focus turned very much back to Europe. This ensured that European corporates continued to trade more cheaply than those in the US, and with financial supply still elevated, the trend continues today.

[1] At the 31 July 2023, Bloomberg.com.

What this means going forward

So why will European corporates rebound? Firstly, when it comes to banking, we believe the Credit Suisse situation is unlikely to be repeated in Europe. There are fewer banks in Europe than the US, and they tend to be bigger, well-capitalised national champions.

This was put to the test in the aftermath of the Credit Suisse rescue when it was very apparent that Deutsche Bank and Société Générale were the most likely candidates to be tested by the market next. However, although the market tried to go after them, it quickly became clear that years of regulation had put them in a stronger place, and they were much more profitable institutions than Credit Suisse.

As for energy, there are still some concerns, but we have come back a long way since the elevated prices we saw in 2022. Some potential for volatility remains, but the companies that might be exposed are in a much better position to deal with it now. They will have hedged their energy prices at lower levels to protect themselves over the winter, meaning credit spreads are unlikely to be affected by energy volatility to the same degree as previously.

Finally, our view on the Russia-Ukraine war is that it is starting to head in a better direction and that by the end of the year, it is possible that the narrative may well be more about de-escalation. This would also lead to some relief in terms of energy prices.

PS...cross-currency is favourable too

Alongside all of this, it is worth being aware that cross-currency conditions also look favourable for euro-denominated debt. Asset managers use short-term FX to hedge out currency risk, and when you adjust the yield dynamic between euros and dollars using this method, euros look attractive.

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