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# European fixed income offers value, not just diversification

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The turbulent start to 2025 has sent many investors seeking alternatives to US assets, but in our view European fixed income can offer more than just diversification.

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## Key takeaways

- US policy uncertainty has highlighted the value of geographical diversification for fixed income investors.
- Europe's seemingly more predictable paths for growth, inflation and monetary policy make this a good time to be increasing exposure to the region in our view.
- European bonds not only offer diversification, but many markets offer a yield premium when hedged back to dollars and we see strong relative value opportunities in sectors such as financials and asset-backed securities (ABS).

The first half of 2025 has forced many fixed income investors to rethink their geographical asset allocations.

Uncertainty around the implementation and effects of US trade and fiscal policy has reportedly cooled appetite for US assets and driven a search for the best alternatives.

In our view, this is an opportune moment for investors to be increasing exposure to European fixed income, not just as a diversification strategy but as a longer term allocation that could enhance returns.

### 1. Europe currently has a more predictable macro environment

Risk asset valuations have recovered strongly in response to the softening of the US stance around tariffs post-April 2. But we think the growth and inflation risks of the policy remain, especially for the US economy.

The European economy is simply less exposed to tariffs, largely because the European Union is negotiating with one (very significant) trading partner rather than dozens at once. Plans for higher government spending on infrastructure and defence have also increased confidence that European growth will pick up, and as a result the downgrades to European and UK growth forecasts since the start of this year have been far less severe than those for the US (see Exhibit 1).

Importantly, Europe's inflation outlook also looks more benign than that of the US, with its smaller projected impact from tariffs being offset by a stronger euro.

Absent the tariff risks, we think the Federal Reserve (Fed) would have cut at its June 18 meeting given the progress on inflation, with Consumer Price Index (CPI) inflation for May coming in below consensus for the fourth month in a row. However, at his press conference Fed chair Jerome Powell noted that policymakers were working with a range of scenarios for both inflation and the labour market that remain difficult to forecast.

By contrast, the European Central Bank (ECB) is also in "wait and see" mode having held rates on June 5, but having cut a number of times already this year to arrive at 2%, bang in line with its estimate of the "neutral rate" which is neither stimulative nor restrictive for the economy.

Our view then is that the Fed would like to cut but effectively can't, while the ECB could cut but doesn't see the need because it is ultimately expecting a minimal impact to growth from tariffs.

This more predictable monetary policy environment, on top of an improving growth story less impacted by tariffs, means we see European (and UK) credit as an increasingly compelling alternative to US credit.

Exhibit 1: Economic projections 2025 – Bloomberg survey

| | | US | Eurozone | UK |
|---|---|---|---|---|
| **GDP, %** | Current | 2.8 | 0.9 | 1.1 |
| | *Year End 2025 Projections* | 1.4 | 0.8 | 1.0 |
| **Core inflation, %** | Current | 2.8 | 2.9 | 3.8 |
| | *Year End 2025 Projections* | 3.0 | 2.4 | 3.1* |
| **Unemployment, %** | Current | 4.0 | 6.4 | 4.3 |
| | *Year End 2025 Projections* | 4.4 | 6.3 | 4.6 |
| **Overnight rate** | Current | 4.5 | 3.0 | 4.8 |
| | *Year End 2025 Projections* | 4.0 | 2.0 | 3.8 |

*Headline inflation. Included for illustration purposes only. Market expectations and forward-looking statements are opinion, they are not guaranteed and are subject to change and should not be viewed as an indication of future performance as actual results may differ materially. Source: Bloomberg consensus forecasts, data as at 2 June 2025.

## 2. European credit can deliver excess return

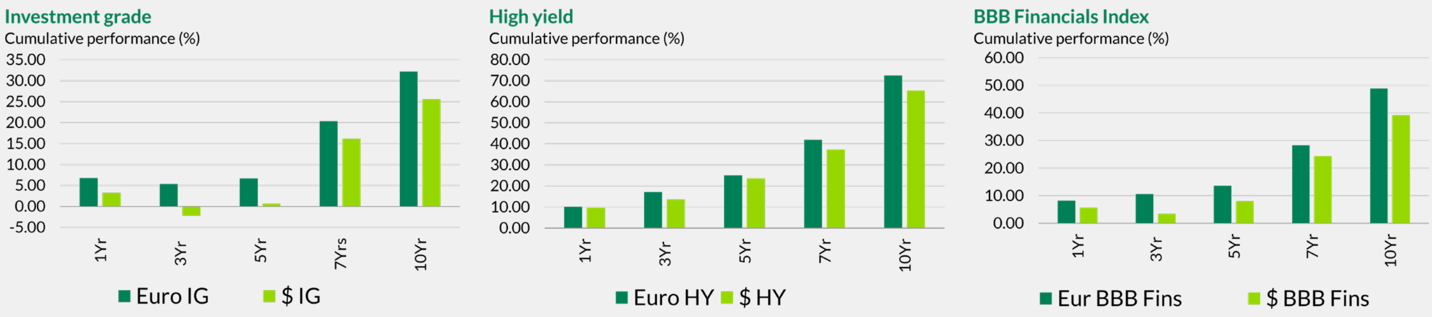
While many investors have been considering reallocating some exposure away from the US, we see little reason for those targeting Europe to expect lower returns as the price for diversification.

Firstly, in many sectors European credit continues to offer a yield premium over the US when hedged back to USD.

As an example, the US Investment Grade ICE BAML Index with an average credit rating of A- yields 5.08% at time of writing, while the Euro Investment Grade Index ICE BAML Index (average rating also A-) yields 5.52% when hedged back to US dollars. The Euro Index also benefits from being shorter in duration (4.6 years vs. 6.4 years), which means lower expected volatility.

In addition, starting yield has tended to be the best predictor of multi-year total return in fixed income, and since European credit has tended to offer higher yield historically, it is not surprising that the European investment grade (IG), high yield (HY) and financials indices have all outperformed their US equivalents in USD terms over the longer term (see Exhibit 2). Indeed, when hedged back to USD – a popular strategy among US-based investors – the European IG and HY indices have outperformed their US equivalents in nine of the past 12 years.

Exhibit 2: Higher yields have meant higher returns for European credit




**Past performance is not a reliable indicator of current or future performance.** Included for illustration purposes only. It is not possible to invest directly into an index and they will not be actively managed. Source: ICE Indices, Bloomberg, 31 January 2025.

## 3. Strong relative value in European financials and CLOs

Within European credit, our top picks are financials and collateralised loan obligations (CLOs), both of which we think offer strong relative value against corporate bond markets of similar credit quality.

European banks recently concluded a strong reporting season for Q1 2025, with most sticking to their full-year guidance and some upgrading their projections despite the uncertainty over tariffs. This contrasts sharply with the corporate sector, where many firms have been forced to suspend guidance in response to the uncertainty around their trading conditions. The sector's fundamentals are also supportive for bondholders – European banks' average Common Equity Tier 1 (CET1) capital ratio remains close to its post-2008 record at just shy of 16%, and the average non-performing loan ratio has been flat below 2% for the last three years.[1]

This strong fundamental picture makes the extra spread available across the financials sector look compelling – this can range from around 50 basis points (bp) for A- rated senior debt over the European IG Corporate Index (average rating also A-), to well over 100bp of pick-up for a typical BB rated Additional Tier 1 (AT1) bond over the BB Corporate Index. The AT1 market has consistently been one of our favoured areas for European financials exposure, and as Exhibit 3 shows, yields here remain elevated despite the steady rally in spreads that has occurred across credit since late 2023.

When it comes to CLOs, we continue to think this asset class offers some of the most attractive risk-adjusted yield opportunities in all of global fixed income.

As Exhibit 4 shows, BB rated CLO notes offer a substantial yield pick-up to the European High Yield Bond Index (average rating BB), while AAA CLO notes offer a slimmer pick-up in yield but to an investment grade (IG) corporate bond index whose average rating is just BBB. In our view, European CLO yields continue to overcompensate investors for what is an impressive historical performance record; since 2002, the annual default rate for sub-IG CLOs has remained below 1% (it is 0% for CLOs issued post-2013), comparing favourably to the long-term average default rate of around 4% for high yield bonds.[2]

Exhibit 3: AT1 spreads have rallied but yields remain attractive

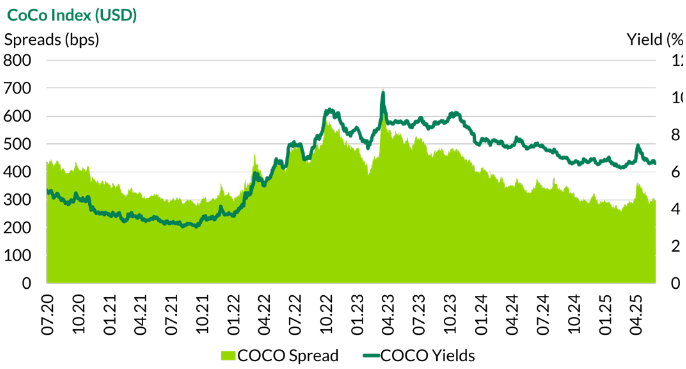



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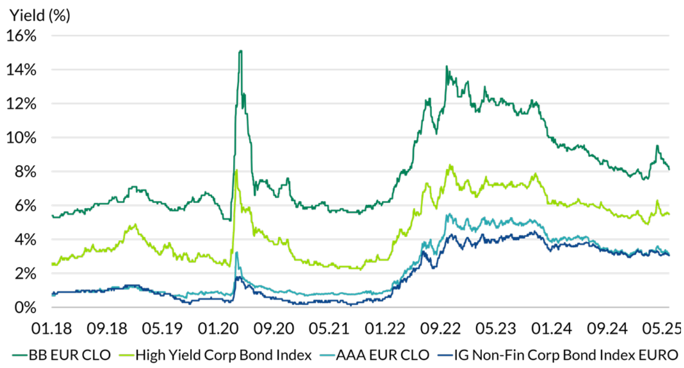
Exhibit 4: CLOs look more attractive than corporate bonds

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1. European Banking Authority, latest data available as at 30 April 2025.
2. S&P Global Ratings, 31 December 2024.

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