November 21, 2024

Global Credit Weekly:

EUR credit: unpacking the resilience

BlackRock

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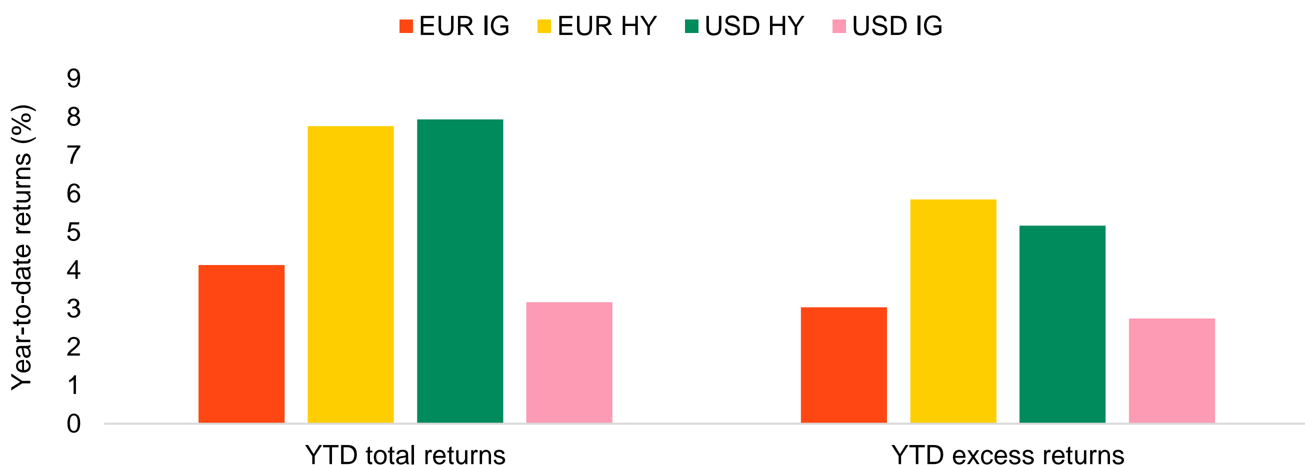
Key takeaways

- Elevated trade policy uncertainty has the potential to weigh on investment in the Euro Area, as a recent analysis from the European Commission highlighted. This would further add to the growth divergence (between the U.S. and Europe) that has been in place for the past several quarters. But the performance of EUR corporate credit has not reflected a weaker Euro Area growth backdrop. For example, the (lower-rated) EUR HY market has outperformed its (higher-rated) EUR IG peer so far this year – on a total return *and* excess return basis (Exhibit 1). And *across* regions, the performance of EUR credit has been similarly resilient (again, Exhibit 1).
- We attribute the relative resilience of the EUR credit market to a few factors, including (1) the European Central Bank's historical precedent of intervening as a purchaser of corporate credit during periods of market volatility; (2) the smaller size of the EUR credit market, relative to the USD universe, which has likely translated into a technical tailwind; and (3) an "up-in-ratings" tilt that is visible within the EUR HY index. Additionally, *U.S.-incorporated issuers* continue to generate a notable share of gross issuance in the EUR IG and EUR HY markets.
- We see the most risk to corporate credit fundamentals in a potential scenario of across-the-board tariffs, which may spark retaliatory tariffs. This has the potential to weigh on corporates' input costs and profit margins, beyond a "one time" upward price level shock. It may also shift consumer consumption patterns, depending on elasticity and substitutions. If severe input cost pressures (or other disruptions to profitability) materialize, corporates may reduce headcount to protect margins, which could have negative consequences for the broader economy.
- As a result, granular credit and sector selection will be important in 2025, given the residual policy uncertainty. Like the view we outlined (for the USD IG market) last week, we see attractive relative value in the Banks sector within the EUR IG universe.

Exhibit 1: Returns for EUR credit have kept pace with USD peers, despite growth risks
Year-to-date total and excess returns, for the ICE-BAML EUR and USD IG and HY Corporate indices



Source: ICE-BAML, Bloomberg, BlackRock. Year-to-date returns capture data through November 18, 2024. Excess returns exclude the impact of interest rate fluctuations. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs, or expenses. Indices are unmanaged and one cannot invest directly in an index.

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Growth divergence appears poised to persist

The growth differential between the U.S. and Europe – which has been in place for the past several quarters, to varying degrees (Exhibit 2) – appears poised to extend into next year.

According to the Atlanta Fed's GDPNow, U.S. real GDP is tracking at an above-trend pace of 2.6% (as of November 19th) and has increased slightly (from 2.4%) since the U.S. election. Bloomberg consensus estimates (which capture a wide range of contributor estimates) call for the U.S. to grow 1.7% in 4Q2024 (quarter-over-quarter, annualized). Meanwhile, Bloomberg consensus growth estimates for the Euro Area are relatively more muted, at 0.8% (again, Exhibit 2).

Downside risks facing Europe

At the European Central Bank's (ECB) October 17th press conference, President Lagarde referenced "recent downside surprises" in economic activity. This was provided as context for why the ECB decided to cut the policy rate by 25bp, marking a back-to-back rate cut from the September meeting. This rate cut was largely unexpected a few weeks prior to the October meeting.

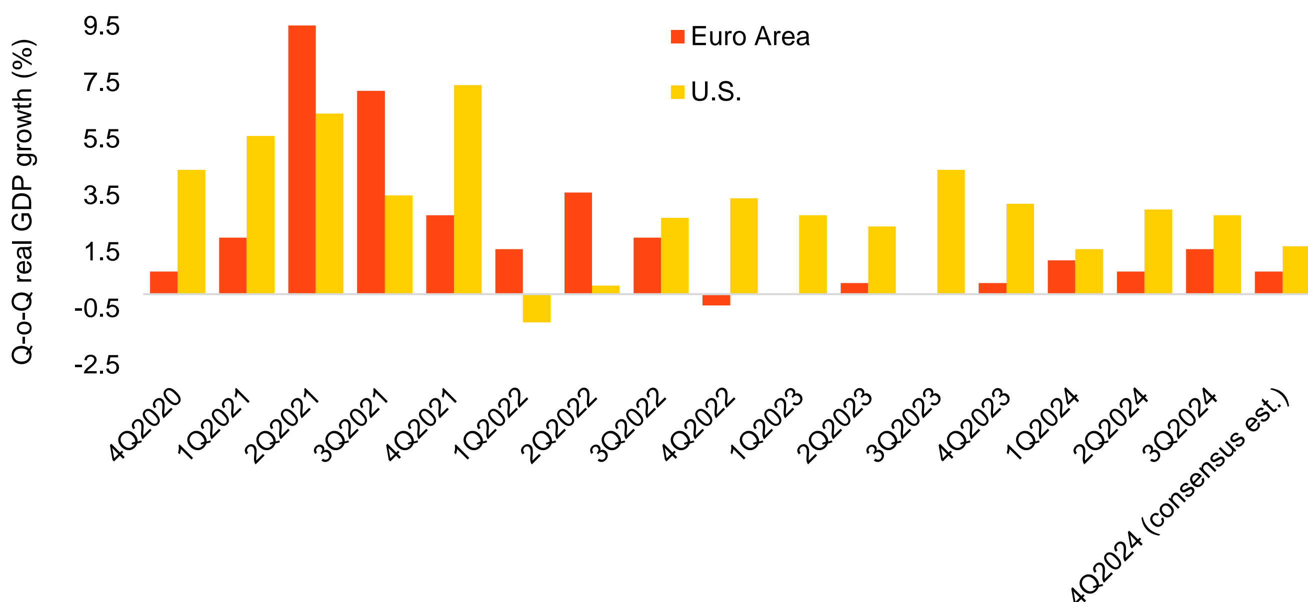
While the contraction in manufacturing activity was especially notable, services activity was also "sluggish" per President Lagarde. She also mentioned that business investment was expanding "slowly," housing investment "continues to fall," and goods exports have weakened. President Lagarde characterized the risks to economic growth in the region as tilted to the downside, owing to a combination of factors including:

1) geopolitical risks, which could disrupt energy supplies and global trade (increasing energy and freight costs, for example), and
2) reduced demand for Euro Area exports, due to a weaker world economy or an escalation in trade tensions between major economies.

President Lagarde addressed the trade-related risks directly, during the Q&A: "Any restriction, any uncertainty, any obstacles to trade matter for an economy like the European economy, which is very open. Trade within itself, of course, but trade also with the rest of the world. Any hardening of the barriers, the tariffs, the additional obstacles to that possibility to trade with the rest of the world is obviously a downside." Indeed, data from Eurostat (the statistical office of the European Union) shows that the U.S. represented approximately 20% of goods exported from the European Union in 2023.

Exhibit 2: Economic policy uncertainty is a risk to Euro Area economic activity

Quarter-over-quarter real GDP growth (%), seasonally adjusted at an annualized rate



Source: BlackRock, Bureau of Economic Analysis, Eurostat. 4Q2024 forecast uses the Bloomberg Contributor Composite as of November 20, 2024. **There is no guarantee any forecasts may come to pass.**

The price of economic policy uncertainty

As the European Commission recently highlighted in their November 15th analysis, heightened economic policy uncertainty weighs on economic activity. The European Commission's analysis leverages the monthly Economic Policy Uncertainty Index developed by professors Scott Baker (Northwestern University), Nick Bloom (Stanford University) and Steven Davis (University of Chicago)[1], which is shown in Exhibit 3.

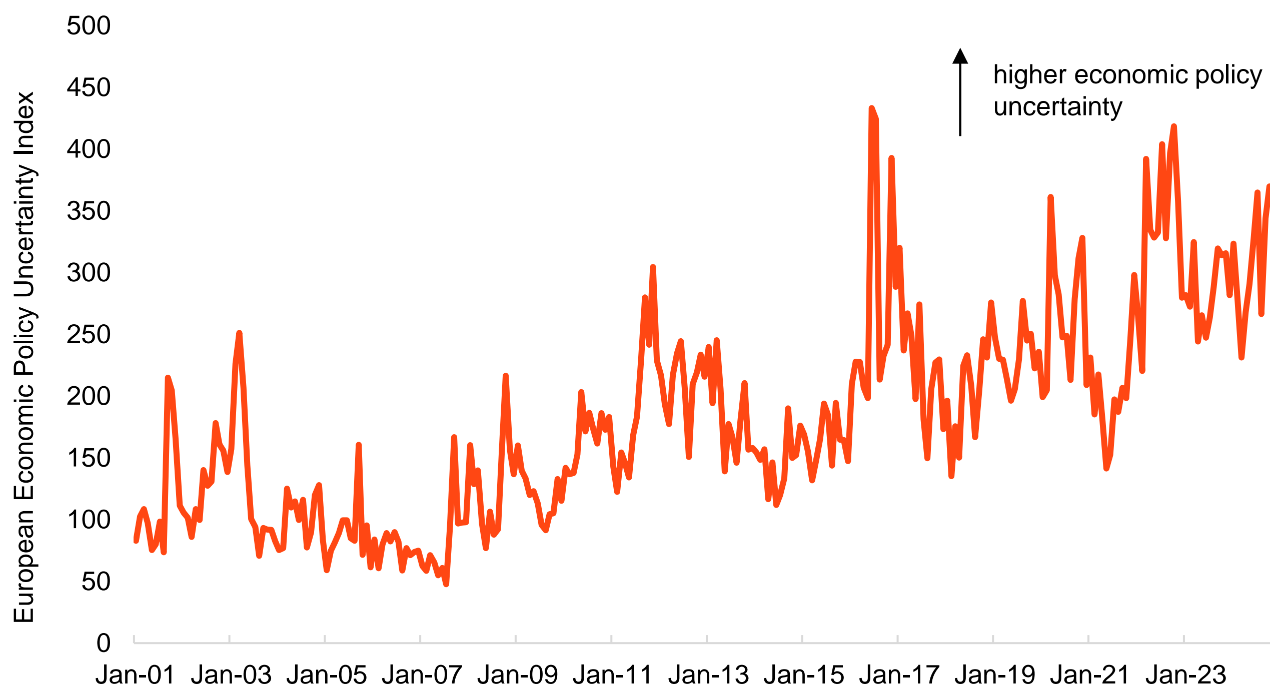
The negative impact was found to be most pronounced on investment, with less of an estimated headwind on consumption. They estimate that "an average-sized exogenous shock to uncertainty" reduces Euro Area real GDP growth by 0.45 percentage points.

The European Commission's scenario analysis also included the following conclusions:

- If economic policy uncertainty reverted to the (lower) pre-pandemic levels (i.e., the period from 1Q2009 to 4Q2019), this could provide as much as a 1.2 percentage point boost to real GDP for the Euro Area. By growth category, the potential boost would be higher for investments (2.8 percentage points) and lower for consumption (1.0 percentage points), under this scenario.
- By contrast, if economic policy uncertainty increases by 50% relative to the post-pandemic levels (i.e., the period from 1Q2020 to 2Q2024), this could provide a headwind to real GDP of as much as 0.6 percentage points. Consistent with the first scenario, the potential headwind to investments would be more pronounced (1.4 percentage points) relative to the potential headwind to consumption (0.5 percentage points).

Exhibit 3: The European Commission's recent scenario analysis points to an investment headwind from additional economic policy uncertainty

European Economic Policy Uncertainty Index



Source: Haver Analytics, Economic Policy Uncertainty Index developed by professors Scott Baker, Nick Bloom, and Steven Davis (more details on methodology can be found at: PolicyUncertainty.com). The European Economic Policy Uncertainty (EPU) Index is based on news articles from two newspapers from each of the five largest European economies: France: Le Monde, Le Figaro; Germany: Handelsblatt, Frankfurter Allgemeine Zeitung (FAZ); Italy: Corriere della Sera, La Repubblica; Spain: El Pais, El Mundo; UK: Financial Times, The Times of London. The number of news articles containing the terms uncertain or uncertainty, economic or economy, and one or more policy-relevant, such as policy, tax, spending, regulation, central bank, budget and deficit terms are counted. All news searches are done in the native language of the paper in question. Each paper-specific series is normalized to standard deviation 1 prior to 2011 and then summed. The series is normalized to a mean of 100 prior to 2011.

[1] Baker, S.R., N. Bloom, and S.J. Davis. (2016) "Measuring Economic Policy Uncertainty." The Quarterly Journal of Economics, Vol. 131, No 4, pp. 1593-1636.

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Trade policy uncertainty: a (recent) historical precedent

The broader term of "economic policy uncertainty" can include a mix of variables, including but not limited to taxes, regulation, trade, inflation, deficits, and monetary policy. In recent months, the uncertainty related to the trade component, in particular, has notably increased. Exhibit 4 illustrates this using the Trade Policy Uncertainty (TPU) Index developed by Federal Reserve Board economists[2] .

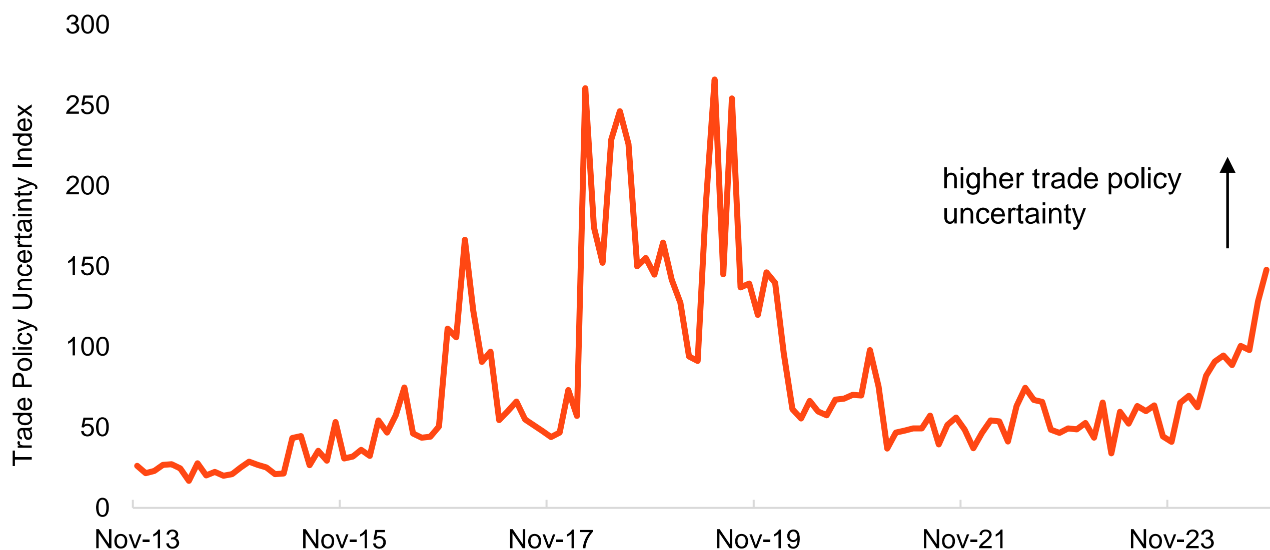
Note: the data captured in Exhibit 4 is updated monthly, and the most recent reading is as of October 31, 2024 – *before* the November 5th U.S. election. As our colleagues in the *BlackRock Investment Institute* have highlighted, we expect significant policy shifts on trade (among other areas) following President elect Trump's victory. This suggests, in our view, that trade policy uncertainty measures have further room to increase relative to the levels shown in Exhibit 4.

The historical precedent – while not a perfect proxy for today's environment – nonetheless provides some directional perspective. For example, a 2019 paper by Federal Reserve Board economists[3] – using the TPU Index shown in Exhibit 4 – found that the rise in trade policy uncertainty in 1H2018 (a period defined by escalating U.S.-China trade tensions and the implementation of new tariffs under the first Trump administration) accounted for a 0.8 percentage point decline in the level of global GDP in 1H2019.

For corporate credit investors, we see the most risk to balance sheet fundamentals in a scenario of across-the-board tariffs (i.e., not targeted to specific countries or products), which may be accompanied by retaliatory tariffs. To the extent that such a scenario materializes, it has the potential to weigh on corporates' input costs and profit margins, beyond a "one time" upward price level shock. It may also shift consumer consumption patterns, based on the elasticity of the good. Depending on the severity of any input cost pressures, corporates may look to reduce headcount as a way to protect margins. So far, U.S. corporate layoff activity has been muted, as characterized by an unemployment rate which remains low by historical standards (4.1%) alongside similarly contained levels of jobless claims.

Exhibit 4: Trade policy uncertainty was already elevated as of Oct. 2024 – and will likely move higher following the U.S. election, in our view

Trade Policy Uncertainty Index (measured monthly)



Source: Haver Analytics, BlackRock. Captures data through October 31, 2024 (most recent as of November 19, 2024). The Trade Policy Uncertainty (TPU) Index is based on automated text searches of the electronic archives of seven newspapers: Boston Globe, Chicago Tribune, Guardian, Los Angeles Times, New York Times, Wall Street Journal, and Washington Post. The measure is calculated by counting the monthly frequency of articles discussing trade policy uncertainty (as a share of the total number of news articles) for each newspaper. The index is then normalized to a value of 100 for a one percent article share. Developed by Dario Caldara, Matteo Iacoviello, Patrick Molligo, Andrea Prestipino, and Andrea Raffo.

[2] Caldara, Dario, Matteo Iacoviello, Patrick Molligo, Andrea Prestipino, and Andrea Raffo, "The Economic Effects of Trade Policy Uncertainty," revised November 2019, Journal of Monetary Economics.

[3] Caldara, Dario, Matteo Iacoviello, Patrick Molligo, Andrea Prestipino, and Andrea Raffo (2019). "Does Trade Policy Uncertainty Affect Global Economic Activity?," FEDS Notes. Washington: Board of Governors of the Federal Reserve System, September 4, 2019, https://doi.org/10.17016/2380-7172.2445.

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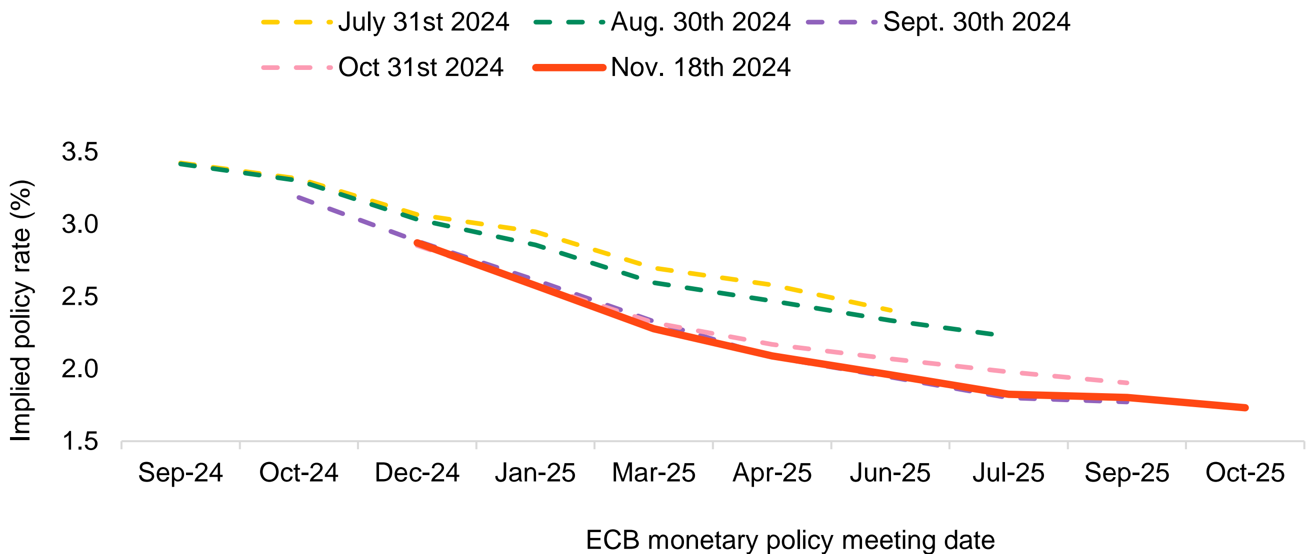
The ECB's reaction function

As downside growth risks have become more pronounced over the past few months, market pricing has implied a deeper rate cutting cycle from the ECB (Exhibit 5). Using Overnight Index Swaps, the market implied terminal rate is in the context of 1.75% by late 2025 (compared to 3.25% as of November 20th).

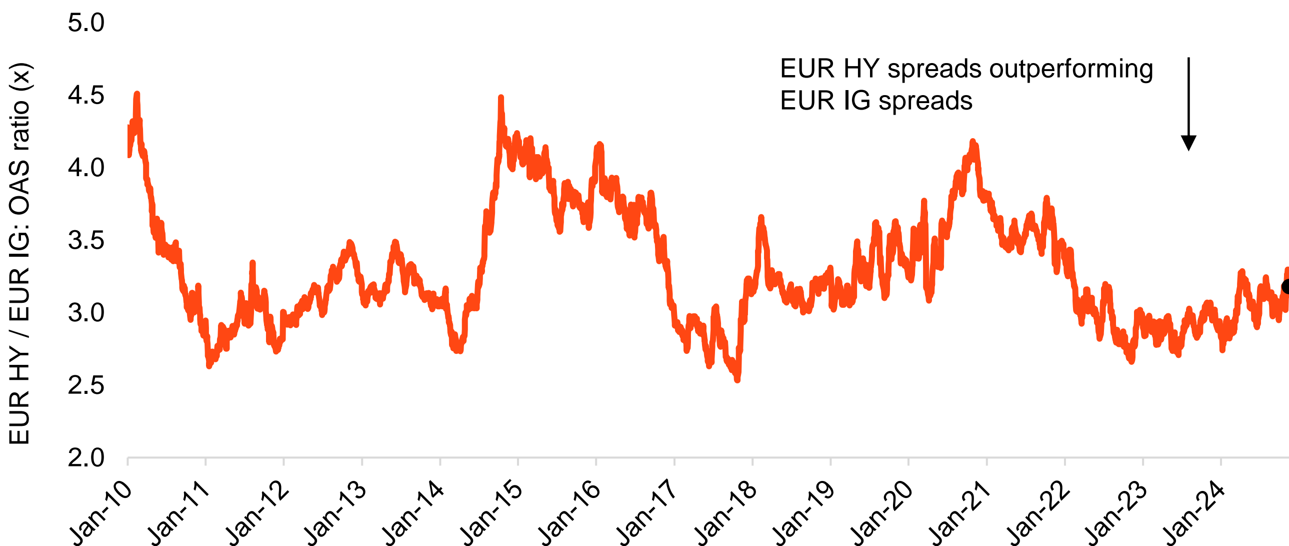
This stands in contrast to terminal rate pricing in the U.S., which has factored in *fewer* rate cuts relative to previous points this year (as we discussed last week). As of November 20th, the market implied terminal rate for Fed Funds (using a combination of Fed Funds Futures and 5y5y Overnight Index Swaps) points to approximately 3.8% by early 2026 (compared to 4.50%-4.75%, currently).

Exhibit 5: Market pricing points to deeper ECB rate cuts, relative to a few months ago
The ECB policy rate path implied by Overnight Index Swaps, at various points in 2H2024



Source: BlackRock, Bloomberg. As of November 18, 2024. **There is no guarantee any forecasts may come to pass.**

Exhibit 6: Despite growth concerns, HY spreads have only slightly underperformed IG in 2024
Option adjusted spread (OAS) ratio for the ICE-BAML EUR HY Corporate Index vs. the EUR IG Corporate Index



Source: ICE-BAML, Bloomberg, BlackRock. As of November 19, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs, or expenses. Indices are unmanaged and one cannot invest directly in an index.

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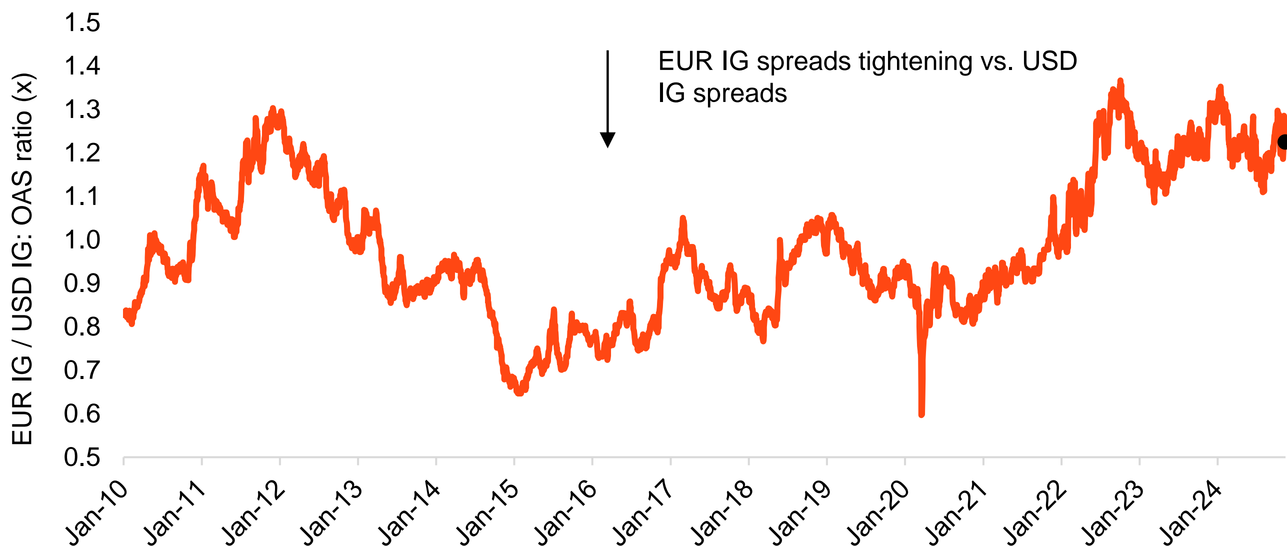
The read-through for EUR credit

Despite the weaker Euro Area growth backdrop outlined earlier, EUR HY credit has outperformed its EUR IG peer so far this year – on a total return and excess return basis (again, Exhibit 1). Exhibit 6 further illustrates that, on a spread ratio basis, EUR HY spreads have only slightly underperformed EUR IG, year-to-date.

EUR credit has been similarly resilient *across* regions. Again, using the data shown in Exhibit 1, EUR credit total and excess returns have kept pace with their USD peers. And as Exhibits 7 and 8 illustrate, neither EUR IG or EUR HY spreads have meaningfully underperformed (relative to the recent ranges) USD IG and USD HY spreads.

Exhibit 7: EUR IG spreads have been range-bound, relative to USD IG spreads
Option adjusted spread (OAS) ratio for the ICE-BAML EUR IG Corporate Index vs. the USD IG Corporate Index



Source: ICE-BAML, Bloomberg, BlackRock. As of November 18, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs, or expenses. Indices are unmanaged and one cannot invest directly in an index.

Exhibit 8: A similar pattern is evident for EUR HY spreads
Option adjusted spread (OAS) ratio for the ICE-BAML EUR HY Corporate Index vs. the USD HY Corporate Index

Source: ICE-BAML, Bloomberg, BlackRock. As of November 18, 2024. **The figures shown relate to past performance. Past performance is not a reliable indicator of current or future results.** Index performance returns do not reflect any management fees, transaction costs, or expenses. Indices are unmanaged and one cannot invest directly in an index.

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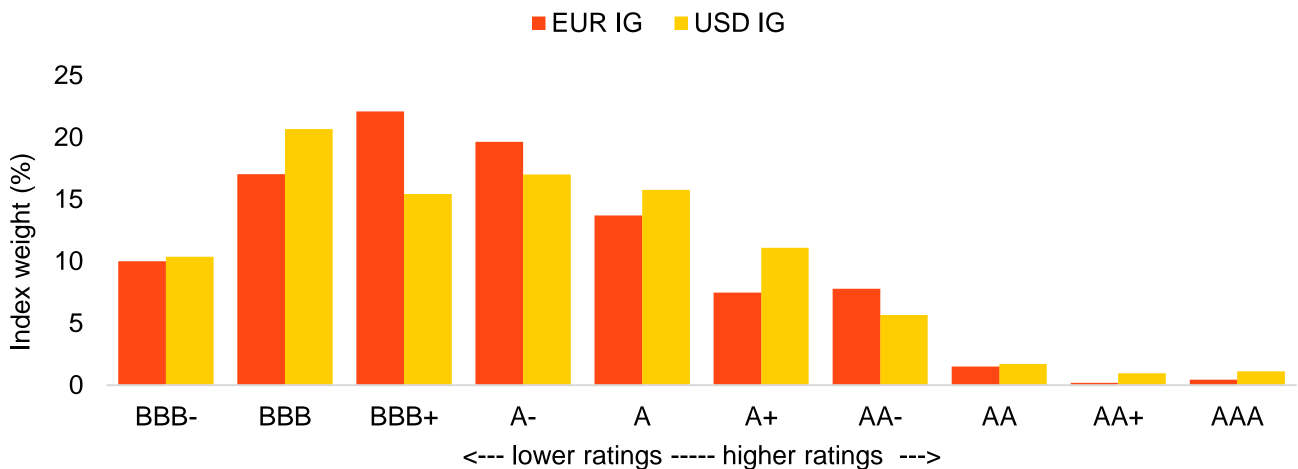
Side-by-side fundamental comparisons

We attribute the relative resilience of the EUR credit market to a few factors. First and foremost, over the past several years the ECB has set a precedent of intervening as a sizeable purchaser of EUR IG corporate bonds during periods of economic volatility via its Corporate Sector Purchase Programme (CSPP), among other facilities. While the ECB is no longer conducting active purchases of corporate bonds, the presence of this mechanism (to help support market functioning) has served to (at least partially) temper market volatility, in our view. It has also likely incentivized investors to move "down-in-quality" during periods when the ECB's purchases of EUR IG credit were elevated. As of November 15th, 2024, the ECB still held €292 billion of EUR IG corporate bonds under the CSPP.

The size of the EUR credit markets are also smaller, relative to USD. For example, using the ICE-BAML Corporate Indices we referenced earlier, the market values (as of November 2024) are as follows: EUR IG: €3.07 trillion vs. USD IG: $8.6 trillion; EUR HY: €380 billion vs. USD HY: $1.34 trillion.

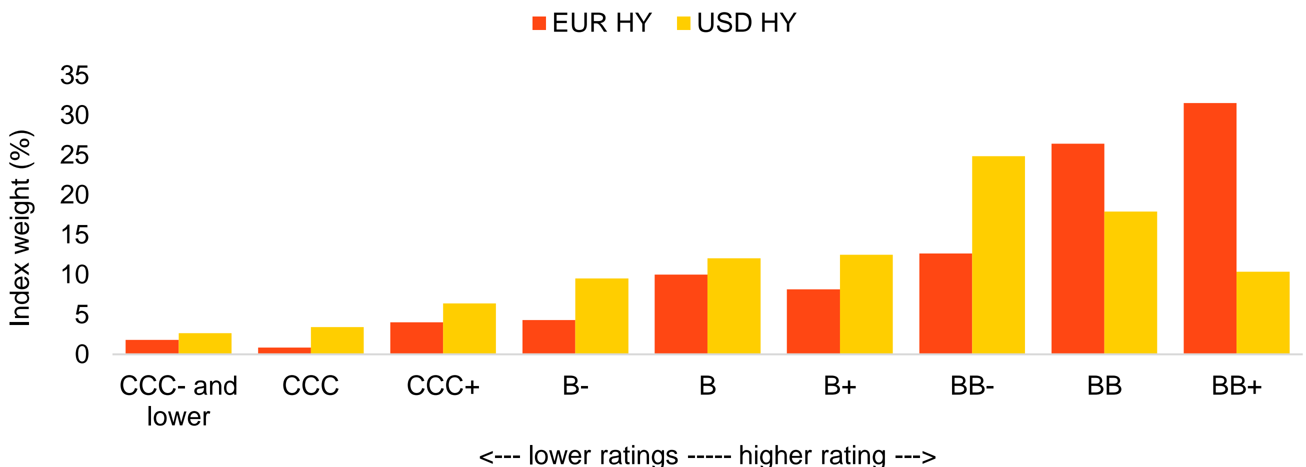
Exhibits 9 and 10 also illustrate how the ratings distributions – within the ICE-BAML IG and HY Corporate indices – compare across the USD and EUR markets. In IG, the ratings are comparable, as both indices have an average composite rating of A- as of November 2024. That said, EUR HY has a slightly higher average rating (BB-) relative to USD HY (B+), driven by a larger weight toward BB+ and BB credits, and fewer CCC rated bonds (across all notches).

Exhibit 9: The USD IG and EUR IG indices both have average composite ratings of A-
Sector weights for the ICE-BAML EUR IG and USD IG Corporate indices



Source: ICE-BAML, Bloomberg, BlackRock. As of November 18, 2024.

Exhibit 10: The EUR HY index has an average composite rating of BB-, while USD HY is B+
Sector weights for the ICE-BAML EUR HY and USD HY Corporate indices



Source: ICE-BAML, Bloomberg, BlackRock. As of November 18, 2024.

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Sector weights are also different between regions, as illustrated in Exhibits 11 and 12. That said, the USD IG and EUR IG indices share a commonality: large weights to Banks (and Financials, broadly). Note: sector weights vary across different USD and EUR corporate indices such as ICE-BAML, Bloomberg, iBoxx, but are generally directionally consistent.

As we outlined last week, we view the Banks and Financials sectors as attractive, owing to their reduced sensitivity in a scenario of escalating trade / supply chain disruptions. We also see scope for capital markets activity (such as M&A) to rebound in coming quarters, which is a source of fee generation for certain subsets of the sector. And as Exhibit 13 illustrates, in the EUR IG market, Banks trade wide (on a spread basis) to a range of non-financial sectors – a differential we expect to narrow.

Exhibit 11: Banks are a large weight in both the EUR IG and USD IG indices

Sector index weights for the ICE-BAML EUR IG and USD IG Corporate indices

	EUR IG % weight	USD IG % weight
Banking	27.6	17.5
Utility	10.4	9.4
Financial Services	6.4	9.7
Consumer Goods	6.1	5.4
Healthcare	5.4	9.8
Real Estate	5.2	3.3
Automotive	5.2	3.0
Telecommunications	4.9	3.5
Transportation	4.7	2.0
Capital Goods	4.4	4.7
Basic Industry	4.4	3.5
Insurance	4.1	4.6
Energy	4.0	8.5
Technology & Electronics	2.1	6.3
Retail	2.0	3.4
Services	1.3	1.4
Media	1.2	3.4
Leisure	0.5	0.4

Source: ICE-BAML, Bloomberg, BlackRock. As of November 18, 2024.

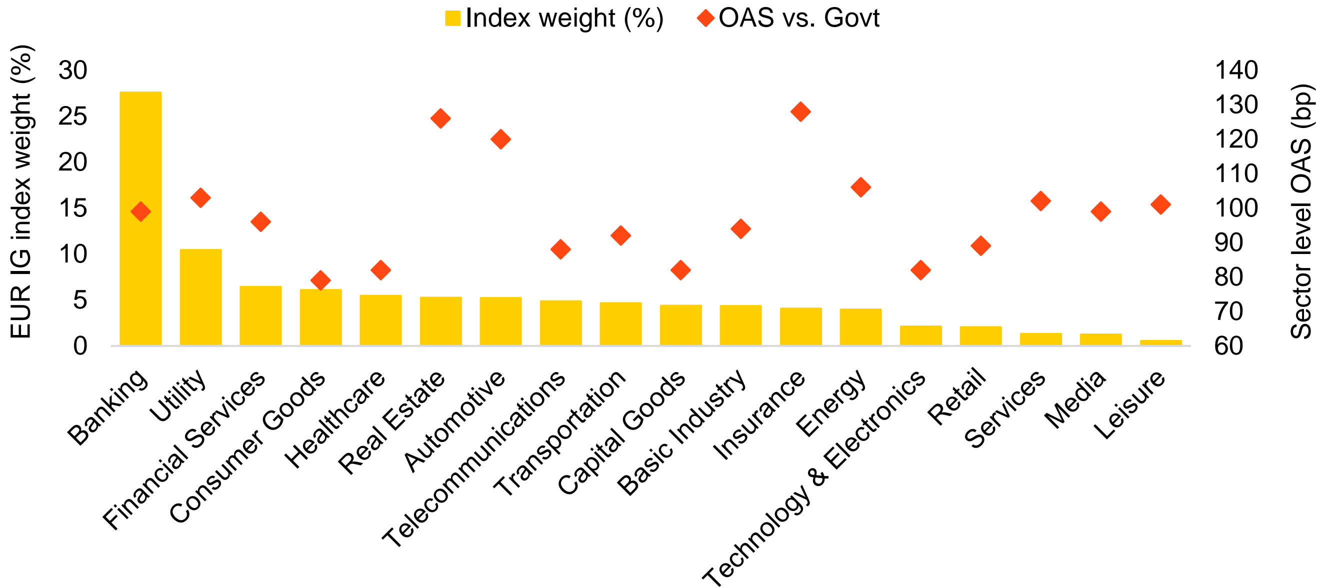
Exhibit 12: EUR HY has a larger weight toward Telecom, while USD HY has a larger weight toward Energy

Sector index weights for the ICE-BAML EUR HY and USD HY Corporate indices

	EUR HY % weight	USD HY % weight
Telecommunications	14.8	5.6
Banking	9.8	0.8
Automotive	9.5	2.3
Utility	8.1	3.3
Healthcare	8.0	8.1
Services	7.7	6.4
Basic Industry	5.7	8.7
Real Estate	5.4	4.2
Retail	5.3	6.2
Capital Goods	5.2	6.7
Leisure	4.1	7.1
Financial Services	3.8	6.7
Transportation	3.3	1.9
Energy	2.9	11.3
Consumer Goods	2.6	3.9
Technology & Electronics	2.2	5.1
Media	0.9	8.7
Insurance	0.6	2.6

Source: ICE-BAML, Bloomberg, BlackRock. As of November 18, 2024.

Exhibit 13: There is a wide degree of variation in EUR IG sector valuations
Sector index weights and option adjusted spreads (RHS) for the ICE-BAML EUR IG Corporate Index



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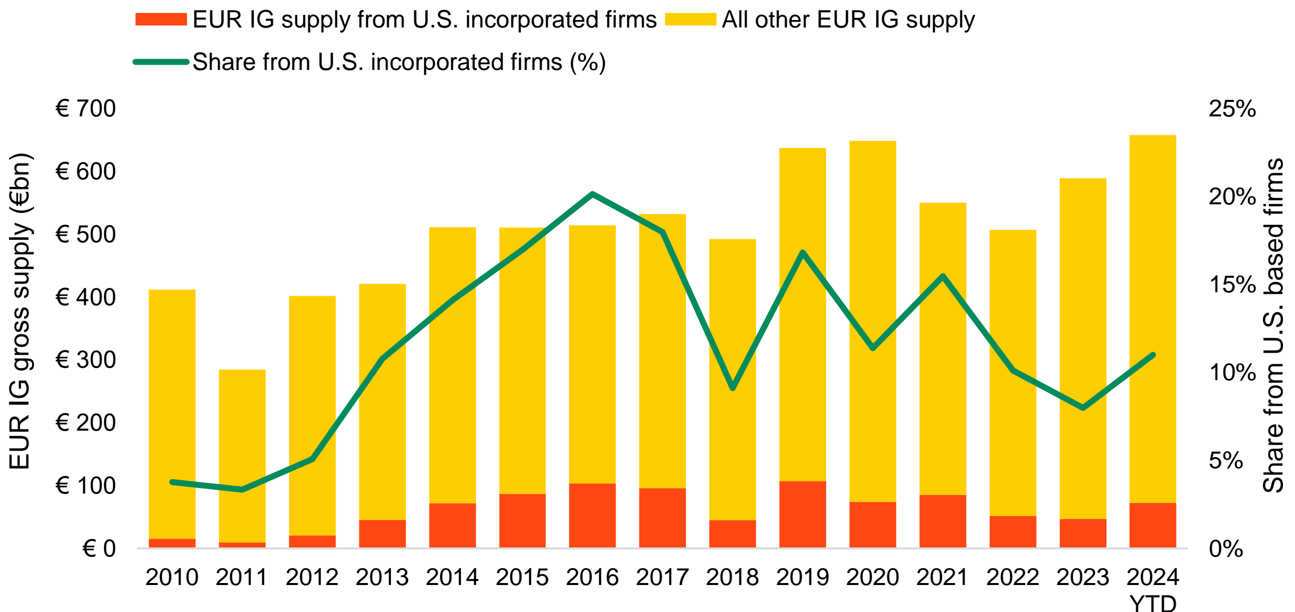
One additional nuance to mention is that the EUR corporate credit markets are not exclusively reserved for European firms. Exhibits 14 and 15 illustrate this by showing the share of EUR IG and EUR HY gross issuance generated by firms with a parent company incorporated in the U.S. This so-called "reverse Yankee" issuance has been a consistent source of supply in the EUR IG and HY primary markets over the past several years and is consistent with the trend of "Yankee" supply in the USD markets (i.e., debt issued by firms with a parent incorporated in Europe).

Exhibit 14: U.S.-based firms generated 11% of EUR IG gross issuance since 2020
EUR IG gross issuance, and the share generated by firms with a parent incorporated in the U.S. (RHS)



Source: Dealogic (ION Analytics), BlackRock. As of November 18, 2024.

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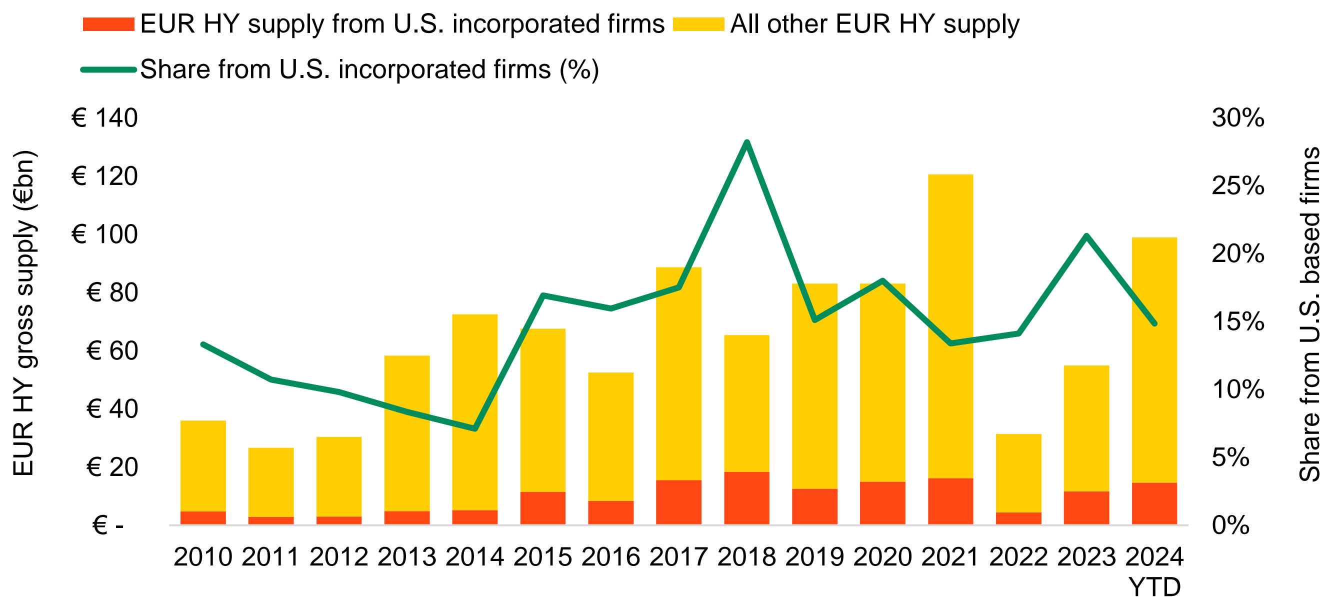
Exhibit 15: U.S.-based firms generated 16% of EUR HY issuance since 2020
EUR HY gross issuance, and the share generated by firms with a parent incorporated in the U.S. (RHS)



Source: Dealogic (ION Analytics), BlackRock. As of November 18, 2024.

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