

Taking credit

April 2024

We prefer European high yield (HY) to US HY on a relative value basis. Option-adjusted spreads (OAS) are wider in € HY and screen as attractive.

€ HY offers attractive carry and a large yield cushion, in our view. We see the broader index as attractive, given its high-quality rating and sectoral composition.

Covered bonds may offer a relative value trade within credit. OAS has fallen for € investment grade (IG), making it relatively expensive, while covered bonds have held steady.

With developed market central banks appearing poised to begin cutting rates in 2024, income levels have likely peaked for this monetary cycle. Following the October rally in credit, this has caused many investors to question where they can find relative value in credit.

We see pockets of opportunity in two segments: European HY and European covered bonds. € HY screens as cheap versus US exposures, while boasting additional yield cushion of 37bps due to its shorter duration profile.¹ Creditor protection in covered bonds – even in scenarios of issuer insolvency, attractive yields, and relative value versus € IG drive our preference for the exposure.

High time for income

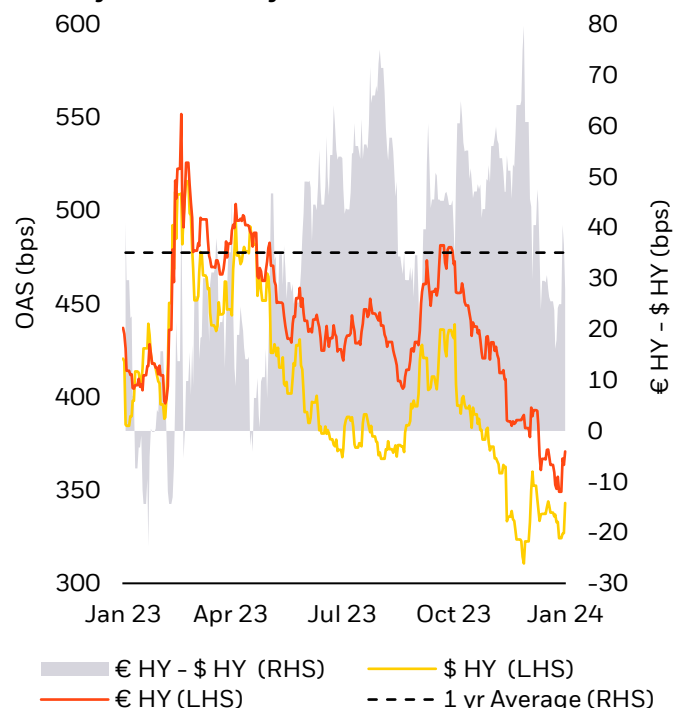
Despite slower nominal growth in the euro area in 2023 as the economy confronted lingering pandemic-induced supply challenges and a slow energy shock unwind, European credit risk indices have fallen to their lowest levels in more than two years.² Throughout 2023, € HY default rates remained muted, falling beneath the long-term median to end the year at 1.3% on a par-weighted basis, thanks to solid fundamentals and reduced refinancing requirements.³ European HY spreads have tightened 57bps year-to-date and 99bps since October 2023,⁴ resulting in a drop in European HY ETP flows from \$1.1B in January to \$0.1B in February and \$0.5B in March.⁵ However, the income opportunity remains attractive, in our view, against a backdrop of structurally lower credit risk.

€ HY offers 5.6% yield compared to 3.6% within € IG,⁶ an attractive yield pickup versus history. We see few catalysts for spread widening in euro credit in the first half of 2024 as higher issuance is met by steady demand from yield-seeking buyers. Spread compression looks sustainable against the lows of 2016 and early 2017, when the duration and intensity of the European Central Bank's (ECB) expanded asset purchases and indications of prolonged stimulus exerted substantial downward pressure on spreads.

Not such close relatives

€ HY screens as attractive on a relative value basis when compared with \$ HY, as the differential in option-adjusted spreads for € HY and \$ HY sits at one-year lows after falling 25bps year-to-date, indicating excess compensation for investors allocating to HY through European exposures.⁷ This is opportune given the favourable macro backdrop in Europe, as monetary policy transmission has peaked, in our view, with real GDP expected to pick up moderately by 0.6% in 2024.⁸ This contrasts with a blurred picture in the US, where growth has remained persistent but could falter amid waning consumer demand.

Chart 1: Relative value of € HY compared to \$ HY, January 2023-January 2024



Source: BlackRock, Bloomberg, as of 31 January 2024.

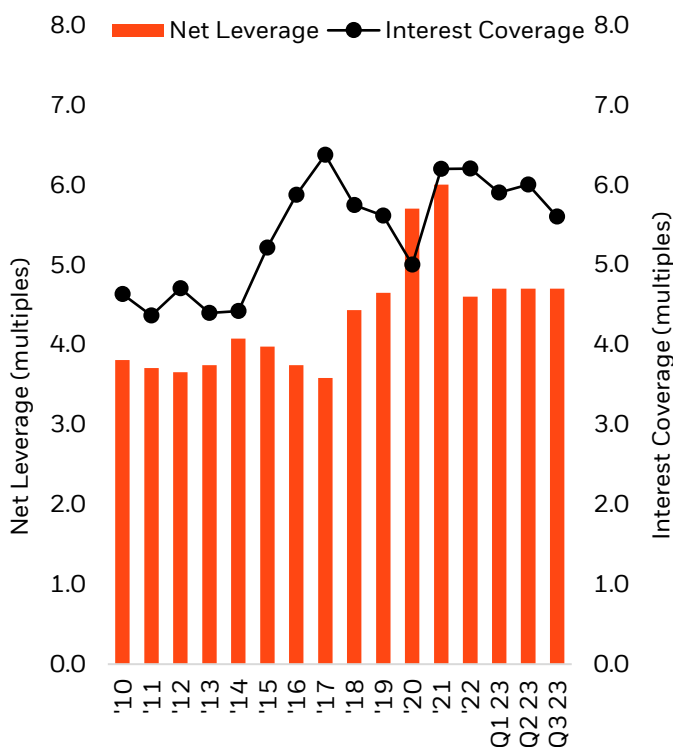
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1,2,7 Source: Bloomberg, as of 5 March 2024. **3** Source: Moody's, ICE BofA, as of March 2024. **4,6** Source: GS Marquee Custom Basket, as of 5 March 2024. **5** Source: BlackRock and Markit, as of 18 April 2024. **Past flows into global ETPs are not a guide to current or future flows and should not be the sole factor of consideration when selecting a product.** **8** Source: ECB, as of March 2024.

Additionally, € HY is supported by an attractive duration profile, which has shortened significantly as a natural consequence of higher rates and increased demand for shorter-duration assets, driven by the need to mitigate interest rate risk. € HY bond indices have seen a notable decrease in modified duration from 4.04 at the start of 2021 to 2.73 in March 2024.⁹ The appeal of shorter maturities within riskier credit is underscored by heightened market volatility and higher term premium providing uplift to yield cushion.

We prefer broad exposure to the € HY market through ICE BofA Euro High Yield Constrained Index for increased diversification, higher credit quality with greater BB and lower single B exposure, and a larger tilt to preferred sectors such as European banks than Markit iBoxx Liquid High Yield Index.¹⁰

Chart 2: Balance sheet strength in € HY market, 2010-2023



Source: J.P Morgan, as of 31 January 2024.

Covering bases

We see covered bonds as a pocket of opportunity within € IG credit, due to the quality and income on offer at cheaper valuations relative to investment grade peers. The option-adjusted spread differential between € IG has fallen 16bps in the last 12 months, and sits 18bps below its three-year average,¹¹ highlighting greater compensation for taking an up-in-quality approach within € IG.

Quality control

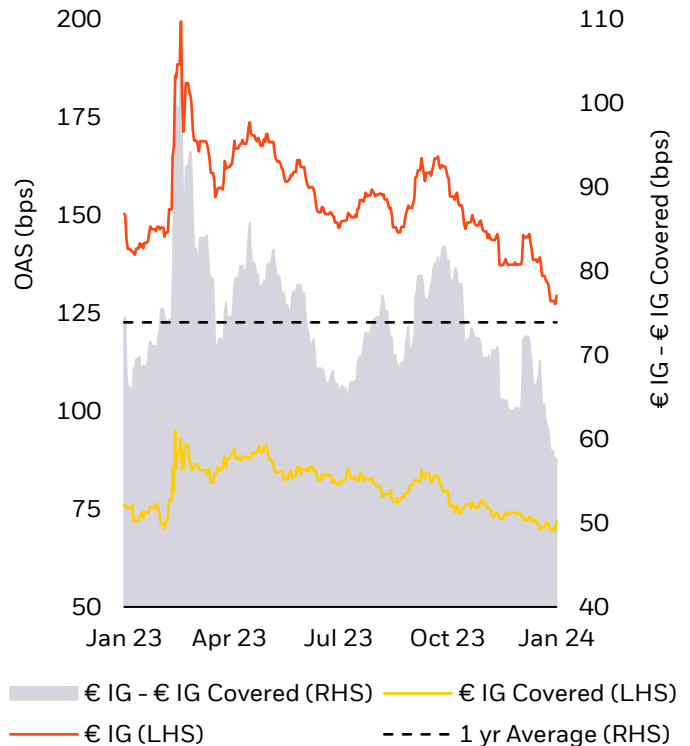
Covered credit represents a form of secured assets, supported by traditional forms of collateral such as residential mortgages. These bonds are predominantly issued by banks, with 95% of the index made up of financials and 73% banks.¹²

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9 Source: GS Marquee Custom Basket, as of 5 March 2024. **10** Source: ICE BofA, as of March 2024. **11, 12, 14** Source: Bloomberg, as of 5 March 2024. **13** Source: Fitch Ratings, as of December 2023. **15** Source: Bloomberg, as of 5 March 2024.

This sector makeup is supportive, in our view, as we maintain conviction on European banks, which have higher return on equity than US banks for the first time in more than a decade. We believe net interest income is likely to stay elevated at least through H1.

Chart 3: Relative value of EUR covered bonds compared to EUR IG, January 2023-January 2024



Source: BlackRock, Bloomberg, as of 31 January 2024.

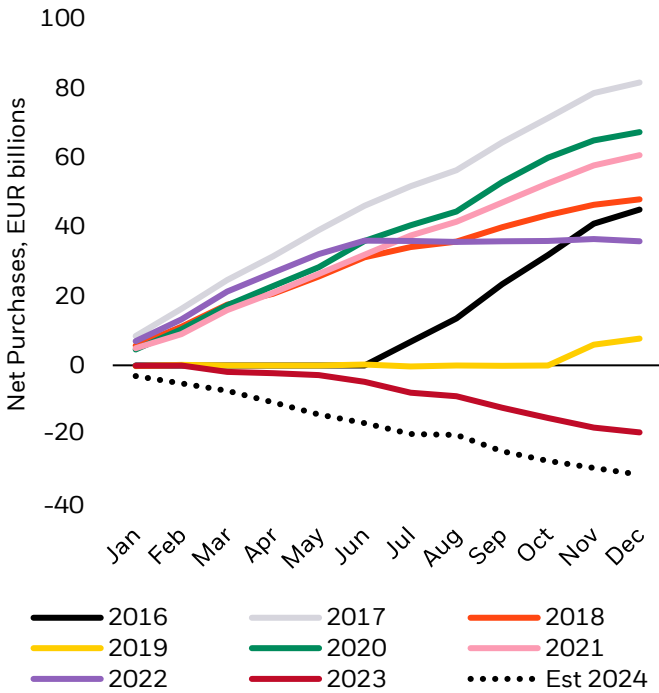
Covered bond holders benefit from dual recourse, entailing a secured claim on the cash flows from underlying assets, even in scenarios of issuer insolvency. Investors also hold priority status as a senior preferred debt holder to the issuer. In 250 years, a covered bond has never defaulted,¹³ making the exposure a compelling income alternative to government bonds, we believe. For example, AAA-rated French bank 7-year covered bonds pay almost 50bps above French AA sovereign-rated bonds, providing investors a significant yield pickup for moving into a higher-rated asset.¹⁴

Looking ahead

€ covered bonds offer a yield of 3.3% and are trading close to their widest levels since the start of the pandemic.¹⁵ This is largely due to huge influges in issuance, as banks use the cheapest form of long-term funding to replace deposits lost from consumers moving to higher-yielding alternatives or funding lost from the ECB as the central bank winds down access to loans through its targeted longer-term refinancing operations (TLTRO). We expect this positive technical factor to continue providing support.

The ECB's unwind of its Covered Bond Purchase Programme (CBPP3) after almost 10 years – see chart 4 – has also helped to sustain elevated spread levels and is projected to bring further stability and liquidity to the market, supporting our preference for € covered bonds.

Chart 4: ECB net purchases under Asset Purchase Programme (includes CBPP3), 2016-2024 (est.)



Source: BlackRock, ECB, EPFR, as of 29 January 2024.

Tail risks

Spread volatility in the € covered market poses risks to our view, potentially triggered by refinancing risks related to asset and liability maturity mismatches when issuing banks can't meet their obligations or by a deterioration in the quality of the collateral pool. Such events are unlikely, in our view, given that the index consists predominantly of AAA constituents and because of significant regulatory protections – for example, strict collateral coverage requirements and 180-day liquidity buffer requirements.

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