Fixed Income Insights
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The Big Mac[1] on Fixed Income

From Tactical to Strategic in EUR Credit

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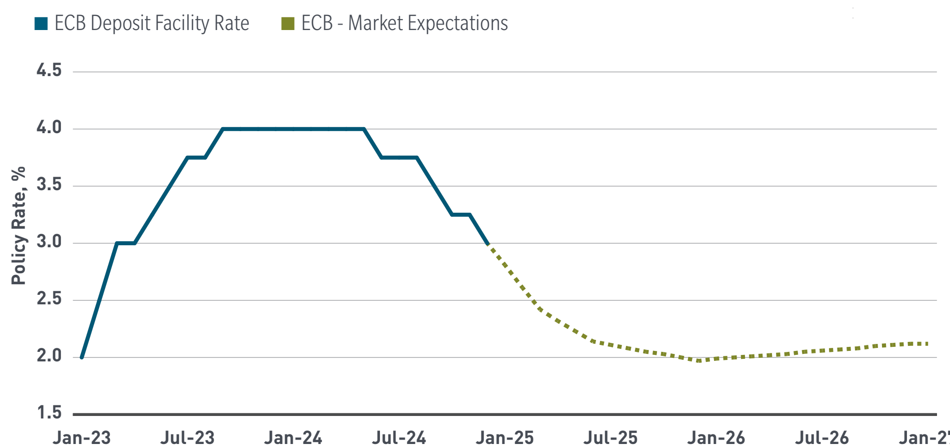
We believe that EUR IG is not only an attractive asset class from a tactical standpoint, but also when considering strategic allocations to fixed income. EUR IG offers compelling defensive characteristics—especially relative to its US counterpart—in a market environment where the need to de-risk multi-asset portfolios may become more pressing. Besides its defensive features, EUR IG offers interesting diversification benefits and has delivered superior risk-adjusted returns over the long term.

The tactical case for exposure to EUR IG remains strong. We believe that the eurozone is a sweet spot in the global fixed income universe. First, the case for being tactically long duration in Europe is compelling, as the ECB will likely deliver multiple rate cuts in the period ahead. Current market pricing suggests that the ECB will cut by about 100bp over the next year, but there is a strong possibility that they ease their policy rate even more, thereby helping promote market rate compression in the process (Exhibit 1). Besides the favorable long duration environment, EUR credit fundamentals remain robust despite the challenging growth backdrop in the region. Finally, EUR IG is supported by its attractive valuation, especially on a relative value basis against its peers, as well as by strong technicals, including healthy inflows into the asset class. On the valuation front, the current break-even spread for EUR IG stands at 23bp or almost double that of US IG (12bp).[1]

Exhibit 1: ECB Policy Rate and Current Market Pricing Expectation



Sources: Bloomberg. Monthly data from January 2020 through December 2024. Implied policy rate based on forward cash curve. Data as of 13 January 2025.

[1] The Big Mac, which is a hint at big macro, is a periodic global fixed income note that discusses relevant topics in the global fixed income/global macro environment.

There is a need to de-risk multi-asset portfolios. We believe that global markets may be at a crossroads, with policy uncertainty and macro volatility set to rise in the period ahead, especially in the context of Trump 2.0. With that in mind, it would make sense to envisage a de-risking of multi-asset portfolios, including through a higher allocation to fixed income. Overall, we believe that fixed income is well positioned as an attractive de-risking asset class, given that all-in yields currently trade at historically elevated levels. On the equity side, while the market backdrop remains broadly supportive of risky assets, there is a growing concern about current market valuations and what they may mean for expected long-term equity returns.

EUR IG is an interesting de-risking asset class option given its attractive defensive characteristics. For a start, the volatility of EUR IG total returns is markedly lower than that of US IG returns, suggesting that EUR IG tends to be less risky. Specifically, over the past 10 years, EUR IG total return volatility stood at 4.8%, or well below the 7% registered for US IG. Likewise, EUR IG also displays a more favorable volatility profile when it comes to the volatility of credit returns, *i.e.*, excluding the returns from the underlying rate exposure. In particular, 10-year credit return volatility stands at 3.4% for EUR IG, against 4.7%, a substantially higher number, for US IG. There are many other ways to measure asset class risks and according to these alternative metrics, EUR IG stands out as a more defensive asset class than its US counterpart. For instance, one of the risk measures that is popular amongst our fixed income portfolio managers is Duration Times Spread (DTS). As illustrated by Exhibit 2, EUR IG produces the lowest DTS in the global credit universe, well below that of US IG.

Exhibit 2: A Measure of Fixed Income Risk, Duration Times Spread (DTS)

	DTS
EMD Sov	1,967
Global HY	1,122
EM Corp	1,028
EUR HY	949
US HY	794
US Taxable Munis	676
CAD IG	547
US IG	545
Global IG	470
EUR IG	428
EUR Agg	320
Agency MBS	258
Global Agg	219
US Agg	198
US Tax-Exempt Munis	104

Riskiest

As of 13 Jan. 2025
Based on spread duration x spreads

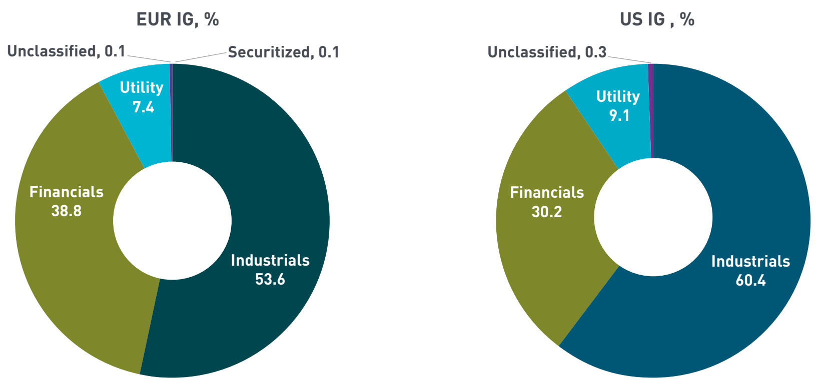
Source: Bloomberg. Data as of 13 Jan 2025. DTS is a measure of risk. DTS = spread x duration. US Agg = Bloomberg US Aggregate index. Global Agg = Global aggregate index. US IG = Bloomberg US Aggregate Corporate Index. US HY = Bloomberg US Corporate High Yield Index. EM Sovereign = J.P. Morgan EMBI Global Diversified Index. Europe IG = Bloomberg Pan-Euro Aggregate Corporate Index. Europe HY = Bloomberg Pan-European High Yield Index. Global credit = Bloomberg Global Aggregate Corporate Index. Canada IG = Bloomberg Canada Aggregate Corporate Index. US Agg-Eligible Taxable Munis = Bloomberg US Taxable Municipal Aggregate Eligible Index.

Similarly, the analysis of the ratio of spread per unit of credit risk is also favorable to EUR IG. Based on an average rating of A3/BAA1, the current spread of 102bp produces a credit-rating adjusted spread of 14bp.[2] This is markedly higher than the 11bp per unit of credit rating adjusted spread displayed by US IG. In other words, investors are better compensated with EUR IG per unit of credit risk.

Finally, while it may not be relevant to analyze outright default rates for the IG credit universe, rating drift is an important consideration. On this front, the long-term up/down ratio—which compares the number of rating upgrades to rating downgrades—has been higher for Western Europe than for the US, pointing to stronger rating dynamics in the region.[3]

EUR IG offers diversification benefits relative to US IG. The first level of differentiation can be found in terms of the index sector composition (Exhibit 3). In particular, exposure to financials is considerably higher for EUR IG relative to US IG, which may be an attractive index characteristic in the face of elevated interest rates. In contrast, the weight of industrials is significantly smaller than for its US counterpart. Likewise, the country of risk exposure is considerably more diversified by design than the US index. For instance, the top 3 countries of risk for the EUR IG index include the US (21%), France (20%), and Germany (14%), whereas in the case of US IG, they are the US (86%), the UK (4%) and Canada (3%), a very different profile in terms of geographical concentration risk.[4]

Exhibit 3: Sector Composition, EUR IG and US IG

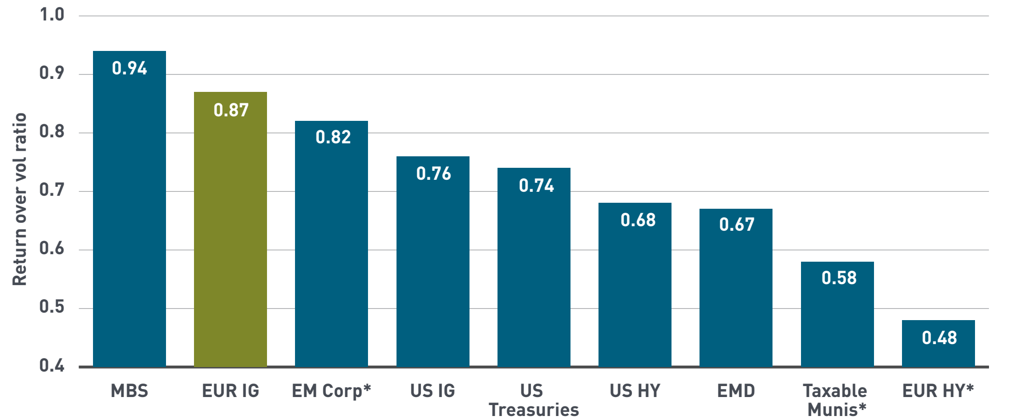


Source: Bloomberg. Europe IG = Bloomberg Pan-Euro Aggregate Corporate Index. US IG = Bloomberg US Aggregate Corporate Index. Data as of 15 Jan. 2025.

In addition, it is worth pointing out that EUR IG's correlation with global equities is markedly lower than that of US IG, suggesting that EUR IG offers some diversification benefits—as well as being more defensiveness—when it comes to exposure to risky assets.[5] We believe that this is an enticing feature given the potential risks surrounding global equities in the period ahead.

EUR credit has produced compelling risk-adjusted returns over the long term. Looking back at historical performance in global fixed income, EUR IG stands out as one of the most attractive asset classes from a risk-adjusted return perspective. Indeed, only US MBS have delivered a stronger volatility-adjusted return since the late 1990s. A ratio of 0.88 for return to volatility is remarkable, in our view, especially when established over such a long-time horizon (Exhibit 4). The strong EUR IG outperformance on a risk-adjusted basis can partly be explained by the fact that historically, the eurozone has provided a more fixed income-friendly macro environment than the US. In addition, the historical performance of US credit, which features higher volatility, has been somewhat impacted by greater return swings.

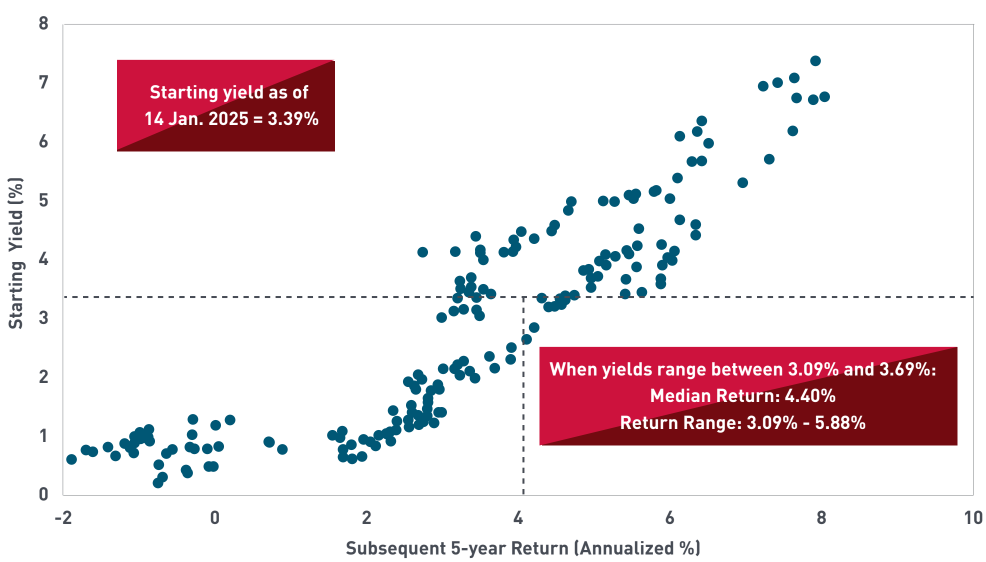
Exhibit 4: Long-Term Risk-Adjusted Returns



Sources: Bloomberg. Ratio is calculated as total return over total return volatility during the same period. Indices used include: US Mortgage = Bloomberg US MBS Index. US IG = Bloomberg US Aggregate Corporate Index. US HY = Bloomberg US Corporate High Yield Index. EM Sovereign = J.P. Morgan EMBI Global Diversified Index. EM Corporate = J.P. Morgan CEMBI Broad Diversified Index. Europe IG = Bloomberg Pan-Euro Aggregate Corporate Index. Europe HY = Bloomberg Pan-European High Yield Index. US Agg-Eligible Taxable Munis = Bloomberg US Taxable Municipal Aggregate Eligible Index. US Treasuries = Bloomberg US Treasury index. Ratio measured over the period of July 1998 to Dec. 2024, except for EM Corp (since Jan. 2002), taxable munis (since sept. 2003) and EUR HY (since Jan. 1999) due to data limitations. Past performance is no guarantee of future results.

Entry points matter for long-term expected returns. Given the current attractive level of EUR IG yields, the outlook for expected returns has improved considerably. This is because there has historically been a strong relationship between starting yields like today's and robust future returns. For instance, at a starting yield of 3.39% for EUR IG, the median annualized return for the subsequent five years — using a 30-basis-point range around the starting yield — stands at 4.40%, an attractive hypothetical return, with a return range of 3.09% to 5.88% (Exhibit 5).

Exhibit 5: EUR IG: Starting Yield vs. Subsequent 5-Year Total Returns



Bloomberg. EUR IG = Bloomberg Pan-Euro Aggregate Corporate Index. Monthly data from January 2005 through December 2024. Past performance is no guarantee of future results.

Overall, we believe that the strategic case for exposure to EUR IG is compelling, mainly reflecting its interesting characteristics and historical return profile.

End Notes

[1] Bloomberg. EUR IG = Bloomberg Pan-Euro Aggregate Corporate Index. US IG = Bloomberg US Aggregate Source Corporate Index. The break-even spread is calculated as the ratio of option-adjusted spreads to duration. Data as of 15 Jan. 2025.

[2] Source: Moody's. This calculation is based on a numerical scale for credit ratings, starting with 1 for Aaa, 2 for Aa1, 3 for Aa2 etc.

[3] Bloomberg, S&P, Moody's. The up/down ratio has been calculated for the period 2015 -2024 using annual data for IG rating moves for both Moody's and S&P for the US and Western Europe, respectively.

[4] Source: Bloomberg. Bloomberg. EUR IG = Bloomberg Pan-Euro Aggregate Corporate Index. US IG = Bloomberg US Aggregate Corporate Index. Country of risk composition. Data as of 15 Jan. 2025.

[5] Source: Bloomberg, MSCI. The 2-year correlation with the MSCI World Index stands at 66% and 85% for EUR IG and US IG, respectively. Based on monthly total returns, calculated over the period Jan. 2022/Jan. 2025 (data as of 15 Jan. for Jan. 2025).

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