FLASH 6 FEBRUARY 2025

Euro high yield corporate bonds: 2025 may not be a repeat of 2024

Key messages

- 2024 was a fantastic year for euro high yield corporate bonds.
- A low default rate over the past 12 months.
- Decent returns are expected in 2025, albeit not as high.
- Spreads are tight and dispersion is set to increase.

Taking stock of 2024

Euro high yield corporate bonds enjoyed a fantastic year, delivering a stellar performance of +8.1% in total returns in 2024. The main driver was spread compression, reflecting the much lower perception of default and liquidity risk. Secondly, the economic backdrop was kind to bonds, with inflation in the eurozone falling sharply, enabling the European Central Bank to start cutting interest rates. And finally, demand. All-in-yields last year were running at attractive levels, and we saw record demand for high yield bonds coming from retail investors.

In a word, the perfect combination of favourable conditions for high yield corporate bonds.

Our outlook for 2025

In today's more challenging economic environment, we expect euro high yield corporate bonds to deliver decent returns in 2025, but probably not of the same magnitude as last year, for three reasons.

Firstly, technical support for the market could weaken. Last year, net bond issuance was limited, making high yield corporate bonds relatively scarce. However, in 2025, we are expecting net supply to turn positive, which should put downward pressure on prices.

Secondly, corporate fundamentals remain solid overall, but there are mounting concerns. Economic growth in the eurozone is expected to be sluggish, and credit quality in the asset class has been deteriorating slightly over the past few quarters.

Thirdly, the broader economic environment remains uncertain. Political tensions within the eurozone and global trade risks could also create more volatility.

Will the low default rate continue?

Yes, it is quite likely. One of the positives for euro high yield corporate bonds is that defaults have been extremely rare. The 12-month default rate is a mere 0.3%. And even with some economic headwinds, we expect it to edge up to 1.5% in 2025, so that would be very low by historical standards. In other words, defaults are not a real concern.

Rather we turn our attention to valuations because they are very tight and logically there is not much room for spreads to compress further. The average spread in bonds is around 300 basis points, or 260bp lower than the historical average. Furthermore, spreads are tight across most of the credit spectrum. BB-rated bonds are trading at 170bp below their historical average, B-rated bonds are 270bp below, and the lowest-rated segment (C-rated bonds) are trading in line with their historical average.

Consequently, the market is already pricing in a lot of optimism. Valuations are tight, dispersion is set to increase, making bond selection even more important.

Edouard Desbonnets
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Expected returns

We can no longer rely on spread compression. Therefore, the total return will come from carry, the income an investor earns for holding a bond. Our forecast of a modest spread widening of 25 basis points would give an expected return of approximately 4% for 2025.

How do euro high yield corporate bonds fair against other fixed income markets?

We believe that investment grade corporate bonds are a good solid alternative for the conservative investor, both in euros and dollars. In the eurozone, they offer similar expected returns to high yield, delivering around 3.5% vs. 4% (HY), but of course there is much less volatility for investment grade bonds, a good option for anyone looking for stability.

For US investment grade corporate bonds, we forecast an expected return of 5.5%. This is better than the euro equivalent, but with more volatility than euro investment grade corporate bonds.

In our view, valuations of US high yield corporate bonds are even tighter than euro high yield corporate bonds. They tend to be riskier, with higher default rates. That said, the US economy is growing more rapidly than in the eurozone, a factor supporting America's credit markets. We have calculated an expected return of around 4.7% in 2025 for US high yield corporate bonds.

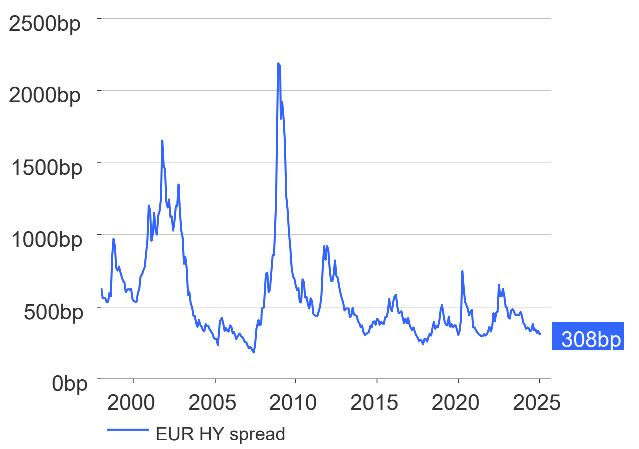
Conclusion

There is limited potential for further spread compression. Thus, carry will be king and will represent the main source of return in 2025.

Investors should be selective because valuations at index levels are relatively tight.

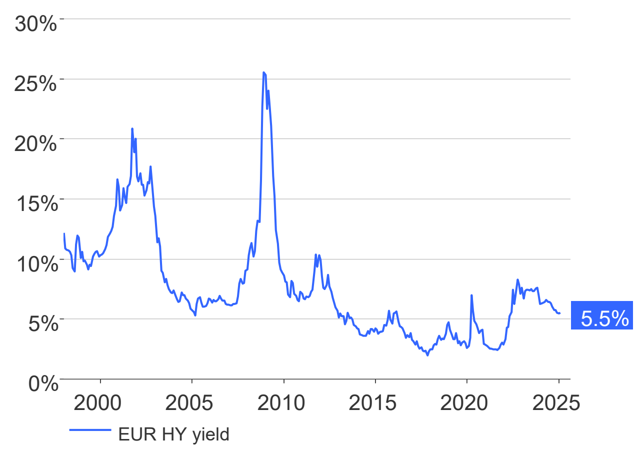
Consider alternatives in the bond universe. Euro and US dollar investment grade bonds offer attractive risk return trade-offs.

NOT MUCH ROOM FOR SPREAD COMPRESSION...



Source: LSEG Datastream, 04/02/2025

... BUT ALL-IN YIELDS ARE HIGH COMPARED TO THE PAST 15 YEARS



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