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Fixed Income

European High Yield Update

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What's been happening in this market?

Since the start of the year, European high yield has experienced bouts of volatility mostly due to geopolitical headwinds. Over the first few weeks of 2025, asset swap spreads had tightened to around 250 bps. As the expectation of higher US tariffs increased, we saw a gradual widening to around 300bps.

Then, after President Trump's tariff announcements on the so-called Liberation Day of 2nd April, they widened as much as 80 basis points in little over a week. His subsequent reversal saw a strong rally back: indeed, by mid-May spread levels were the same as they were before the trade war began. They have moved in a narrow range ever since.

What's the Outlook?

At the start of 2025, our base case outlook was for a continuation of the soft-landing that began in 2024 and we expected an investment return-profile to be centred around income. We thought there was a risk that US tariffs might provide the Federal Reserve (Fed) with less scope to cut rates but we certainly did not expect Liberation Day.

So, whilst our expectations have been broadly correct, the levels of volatility have certainly been higher than we predicted. Despite this, we continue to expect total returns for European high yield to remain income-driven for the second half of the year.

Obviously, it's now clear that this destination is unlikely to be linear; after all, there are plenty of months left for more Trump-induced chaos. This includes the ongoing situation in the Middle East, of which the macroeconomic and geopolitical impacts we continue to closely monitor.

But what we certainly aren't doing is getting overly concerned about the shape of our asset class. Whilst Liberation Day demonstrated that Europe is never able to entirely avoid storms emanating from the US, there are sources of comfort. In contrast to the Fed, there is next to nothing now standing in the way of further European Central Bank rate cuts.

Our year-end forecast for the deposit rate is just 1.5%. This is supportive of credit conditions and, most importantly, company fundamentals. European high yield corporates are stepping into this new environment in good shape: leverage ratios remain low (and trending lower) and interest coverage ratios remain high (and trending higher).

In combination, it's difficult to point to a tangible reason to increase our expectations for default rates over the next 12 months. Finally, there remains the strong technical support for the asset class. Not only did this remain in place throughout the recent volatility, but muted net supply volumes are likely to continue as M&A and leveraged buyout appetite dries up.

How are we positioned?

European short-duration high yield proved to be resilient amid the volatility experienced in April. We maintain a preference for higher quality credit, particularly BB. Where we look beyond the high-quality names, we do so only for lower-quality picks that we have high conviction in.

Whilst the events of early April mean we are being extra selective about these names, they should help to boost overall yield. We believe the front-end of the curve is a good place to ride out the rest of 2025.
Undoubtedly, the second half offers the potential for plenty of downside risks, however as shown during April, short duration's defensive profile means we would expect this asset class to be capable of performing well in such conditions.

Source: AXA IM as of June 2025