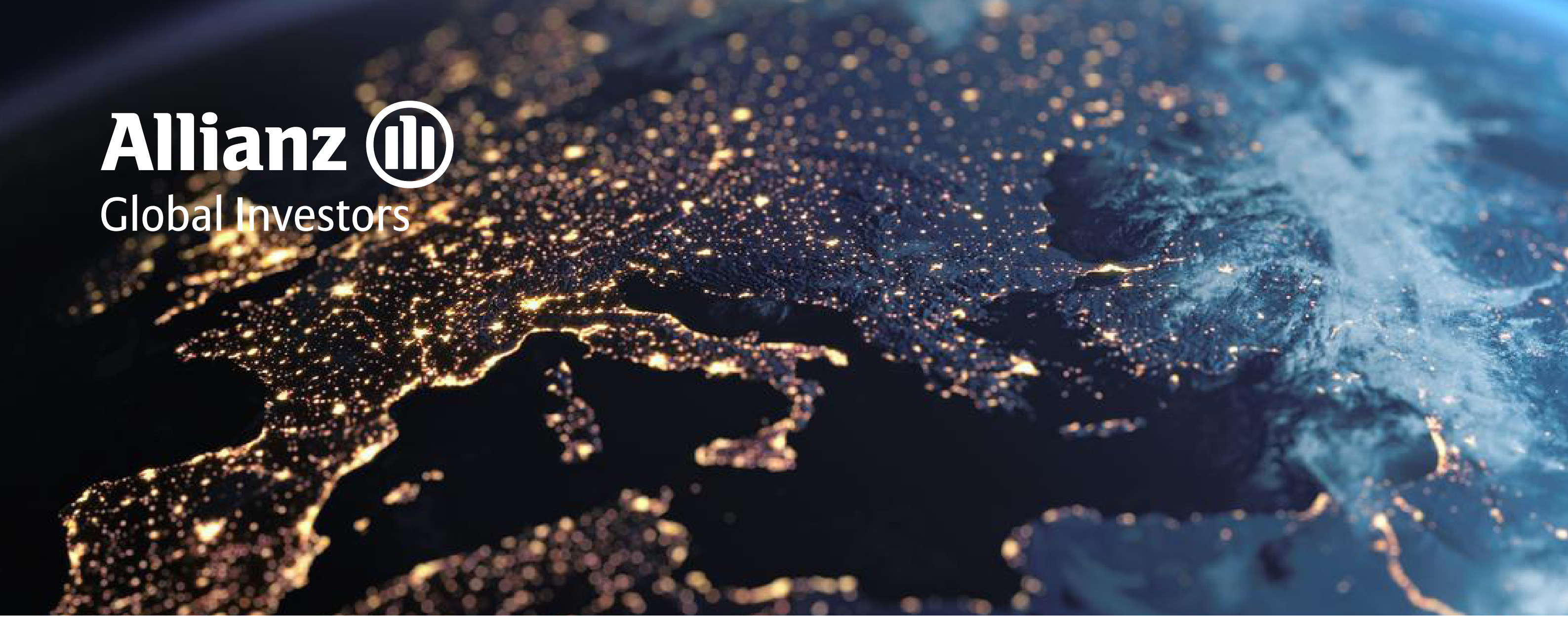

APRIL 2025

Why security selection and quality are key in European credit

With US President Donald Trump's reciprocal tariffs, alongside increased European defence spending and German fiscal expansion, the environment for European credit is developing fast. We examine the outlook for European credit, sector by sector, in the coming months.

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Mr Trump's disruptive approach to policymaking is shaping a new world order and causing a shift in political and business dynamics. Notably, his recent announcement of reciprocal tariffs has sparked significant global reactions and increased risks to global growth, with outcomes now heavily dependent on ongoing negotiations. Meanwhile, in response to increased geopolitical uncertainty, the European Union has proposed a major initiative, "ReArm Europe", which aims to mobilise up to EUR 800 billion to bolster the EU's defence capabilities. Alongside these developments, the German Bundestag voted in favour of reforming the so-called "debt brake", which will relax borrowing limits and allow new investments in defence, infrastructure and climate initiatives.

KEY TAKEAWAYS

- Potential winners in European credit include sectors expected to benefit from increased government spending such as the aerospace and defence sectors, as well as building materials, construction and capital goods.
- But the automotive, alcoholic beverages and luxury goods sectors could face challenges owing to US tariffs.
- Given heightened macro uncertainties, we're taking an agile approach to European credit, with a greater emphasis on security selection and a tendency to move up in quality.

In this changing landscape, we summarise which European credit sectors we think have a positive or negative outlook in the coming months, from the perspective of fixed income investing.

Aerospace and defence – positive outlook (short to medium term)

We expect increased European defence spending to impact the sector positively in the medium term, particularly with an enhanced defence budget that focuses on equipment acquisitions. European defence companies, which may already be operating at full capacity, will need to invest heavily in production capabilities, supply chains and staff – all of which will contribute to growth in the sector. Global tariffs on, for example, aircraft parts could complicate supply chains and raise costs. However, defence production generally relies on domestic manufacturing due to strict regulations, which may mean the sector is more resilient than others in the face of tariff disruptions.

Autos – negative outlook (short term)

A 25% tariff by the US on imported cars represents a significant headwind for European auto makers, many of which export to the US. Passing on the cost of tariffs to consumers looks impractical – except, perhaps, in the ultra-luxury segment – because it would render European models uncompetitive versus American competitors. Some European auto makers may respond by reducing the vehicle line-ups they offer in the US, discontinuing some models, and potentially relocating some of their manufacturing plants to the US, all of which would likely weigh on profit margins. In the long term, German spending plans could provide a boost to the sector, but in the immediate future the outlook is challenging.

Building materials, construction, capital goods – neutral outlook (short to medium term)

The largest European heavy material producers have significant local production in the US, while the country is a net importer of cement. That puts these businesses in a favourable position compared with smaller competitors that rely on imports from Mexico, Canada and other countries. As regards European capital goods, those companies produce mainly locally. Thus, US tariffs are unlikely to have a significant impact on these sectors. In contrast, Germany has announced large infrastructure investment plans, with EUR 100 billion dedicated to climate and economic transformation, which could significantly boost demand for construction materials.

Alcoholic beverages – negative outlook (short term)

The US is the largest export market for many European alcoholic drinks. Tariff uncertainties remain high, and while some European companies may have scope to adjust their supply chains before they resort to raising prices, we would nevertheless anticipate a negative impact in the short term. Categories already facing declines, such as wine, may suffer most. On the other hand, imported beers may manage better as most of them are considered “premium” products in their niche, which means customers are generally more willing to tolerate price rises. We would expect the negative effects of tariffs to be felt quickly in this sector, outpacing any anticipated economic recovery from Germany.

Pharmaceuticals – neutral outlook

Pharmaceuticals are currently exempt from reciprocal tariffs under Mr Trump's recent trade policy. However, they may be impacted by a separate plan, as a 25% pharma tariff has previously been mentioned by the US administration. While many European pharmaceutical producers that sell drugs to the US have local production facilities, the global supply chain remains crucial, and any potential future tariffs could increase costs. However, we think the negative impact of these tariffs could be mitigated by moving production to the US, a trend that has been observed recently. Despite potential short-term disruptions caused by the tariffs, we believe the sector will not be the most adversely impacted, particularly given ongoing growth in volumes.

Luxury – negative outlook (short term)

European luxury firms generate approximately 20% of revenue in the US. Hence, any US tariffs would adversely affect this sector in the short term. The potential tariff disruptions come at a difficult time for the luxury sector, which last year experienced a fall in luxury sales in China, a country that represents roughly a third of the global luxury market. We think the current environment implies a negative impact on the sector in the short term.

German utilities – neutral outlook

Germany's proposed infrastructure investment fund is likely to entail spending on energy infrastructure, which ought to benefit utility companies. Power transport operators may gain from capital injections or cheap funding to support significant investment needs over the next decade. However, we believe rising interest rates could dampen returns for regulated activities. Overall, we think the impact on the sector will be neutral.

Semiconductors – slightly negative outlook (short term)

Recent tightening of EU restrictions on semiconductor sales, particularly to China, highlights growing geopolitical risks for European chipmakers. While we think China will continue to depend on European lithography and other semiconductor technologies in the short to medium term, its aggressive pursuit of semiconductor self-sufficiency poses long-term risks to foreign chipmakers that export there. In the medium to long term, increased spending on infrastructure and defence, in Europe and elsewhere, could boost demand for industrial and military-grade semiconductors; however, this impact is likely to be limited, as defence-related sales represent only a small portion of these companies' overall revenue. We therefore expect a negative impact on the semiconductor sector.

Banks – neutral outlook

Trade tensions between the US and Europe are not expected to impact the financial sector significantly. Most banking activities are domestic due to local legal frameworks, products and clients. This means that, although cross-border clients may face challenges, the risks for lenders are largely indirect. In terms of potential tailwinds, the current push for financial industry deregulation in Europe – which is gaining momentum following deregulation in the US – is unlikely, in our view, to result in reversing any aspects of the Basel III banking framework. We do not therefore expect a significant short-term impact. Nor would we expect a potential ceasefire in Ukraine to have a substantial immediate effect on banks. We would not expect European authorities to lift Russian sanctions in the short term, especially given the ongoing perception of Russia as a threat.

Real estate – negative outlook (short term)

Real estate cannot be "imported", which means this sector is immune to US tariffs. However, if interest rates rise in Europe due to increased financing needs from the new German spending plans, it could present a headwind for real estate companies. Our scenario analysis suggests a sustained increase in German Bund yields over 3% might damage real estate companies' interest coverage ratios. That could create refinancing risks for firms with weak balance sheets. We therefore expect a negative impact in the short term.

European insurance – neutral outlook

The insurance sector is traditionally resilient in the face of macro and geopolitical uncertainty, since it benefits from various idiosyncratic fundamental drivers. These include rising premiums in property and casualty insurance and structural drivers of growth in the life market. Earnings have remained relatively resilient to market headwinds, such as interest rate moves and macro risk, and we do not expect this to change in the short term.

Chemicals – negative outlook (short to medium term)

We do not anticipate significant direct effects from tariffs, as the "local for local" business model is commonly adopted in the chemicals sector. However, we believe the industry will suffer due to demand destruction caused by inflation resulting from these tariffs. There are some positive signs – the European chemicals sector stands to benefit from German infrastructure spending, given its strong ties to the construction industry. On balance, though, we expect a negative impact in the short to medium term.

Telecoms – neutral outlook

European telecom companies are mostly shielded from tariffs, with minimal direct impacts. Companies with substantial revenue from emerging markets could see indirect – but in our view manageable – effects if tariffs result in currency devaluations and exchange rate volatility. We anticipate a neutral outlook for this sector.

Paper and packaging – slightly negative outlook (short term)

Tariffs primarily affect glass packaging companies that serve export-oriented customers. Higher prices may hurt sales volumes for mid-range products, while premium brands may have more flexibility in pricing. We anticipate a slightly negative impact in the short term.

OUR APPROACH IN THIS ENVIRONMENT:

Active management and bottom-up analysis

Clearly, the developing market dynamics will affect corporates differently. Some sectors are already feeling the effects of US tariffs, while others are relatively unscathed. German infrastructure spending is expected to have a positive impact on sectors such as construction; other sectors may benefit indirectly. Defence companies across Europe are likely to benefit as the EU seeks to increase average defence spending by an additional 1.5% of GDP.

In this environment, we continue to recognise the benefits of European credit. In recent years, following a shift in the interest rate environment, many investors have been attracted to this asset class by high overall yields, high quality of issuers and diversification benefits. We maintain our constructive stance on European investment grade credit due to solid fundamentals and strong technicals, supported by attractive all-in yields.

As an active manager, we actively control the overall credit risk of our portfolios by dynamically evaluating valuations, market technicals and credit fundamentals of the issuers within our investment universe. While we believe we can add value across all market cycles through careful security selection, we also acknowledge that certain periods require a more conservative approach with lower credit beta. Given the heightened macro uncertainties and growing dispersion in corporate earnings recently, we have adopted a more nimble and agile approach, placing a greater emphasis on security selection and a tendency to move up in quality. Valuations are not particularly cheap after a prolonged period of spread compression, which requires more careful selection of securities based on their risk-adjusted return expectations. In this fast-moving environment, we believe more than ever that investors should adopt an active investment approach.

April 2025 DG-SM