

European Credits Across Multiple Segments

“What we forget can be just as important as what we remember”.

Looking beyond volatility—driven by geopolitical tensions in the Middle East, AI-related disruption fears, and shifting market sentiment—it is important to reassess whether a constructive medium-term outlook for economic growth and risk assets still holds, or whether asset allocation should be adjusted accordingly.

The investment landscape has undeniably become more complex. The macro backdrop has evolved: monetary policy expectations have shifted—if not fundamentally changed—amid inflation concerns and rising fiscal pressures; credit spreads have widened at a pace that appears warranted, and in some portfolios I had the opportunity to check, the traditional hedges have proven less effective than expected. Once again, market participants have been reminded that credit correlations, during market turmoil, tend to rise sharply in the tails, often exceeding prior numerical estimates and assumptions. This is something I often warn quantitative people about.

Despite the wide range of potential outcomes, a selective approach to risk assets remains justified. Exposure should be maintained in areas where valuations appear attractive, while being reduced in segments where the risk-return profile has deteriorated. When risk sentiment becomes “fragmented”, as I define it, there are meaningful implications for the relative valuation dynamics between asset classes. This is obvious, but it’s still preferable to blanket advice that recommends staying “conservative or sitting on your hands in cash”.

Key observations from Q1:

1) Yield curve dynamics

In Europe interest rate curves flattened, with shorter maturities underperforming—a trend observed not only in European markets but also in U.S. Treasuries and UK Gilts. This dynamic contributed to the underperformance of many investment-grade (IG) and high-yield (HY) credits in Europe, and has meaningful implications for future duration positioning and yield curve steepener strategies. Is the short end cheap, or does the long end offer better medium-term value? One important consideration: the lagging performance

of the European high-yield market relative to the US, across both total and excess returns, is best explained, in my opinion, by liquidity factors, market depth, and different investor base. No further conclusions can be drawn; US credit is supported, in the short run, by higher interest rates, while in Europe demand is more inelastic along the curve and therefore weaker.

2) Credit spreads and sector dispersion

Spread premia widened broadly, led by underperformance in credits exposed to AI competition. Portfolio managers are still assessing their exposures and the potential impact across issuers. Looking ahead, default rates are likely to rise, and credit markets may continue to widen over the medium term. Financial resilience is beginning to weaken in highly leveraged companies, particularly amid subdued earnings and weak cash flow generation. While overall spread widening may remain contained, dispersion across sectors is likely to increase significantly. This divergence is not yet fully priced in, especially as idiosyncratic risks become more frequent. As seen in Q1, during periods of compressed risk premia even modest shifts in spread conditions can generate disproportionate market concern in credits that would ordinarily remain isolated.

As far as portfolio composition is concerned, asset allocation appears slow to adjust—even in CLO portfolios—reflecting constrained primary supply and a sluggish secondary market. This explains the modest changes in holdings across European credit managers.

3) Contrarian strategies underperformance

Contrarian opportunities have not delivered as expected. This is particularly evident in distressed or restructuring situations, where anticipated recoveries have been low or weaker than projected. Bottom-fishing has not proven to be an effective strategy. In Europe unsecured and subordinated debt instruments have also underperformed, contributing to investors disappointment and weak returns. This angle is seldom addressed in Europe, with portfolio managers generally reluctant to comment (impatient purchases made in the pursuit of high yield often lead to poor long-term investment outcomes). I cannot reference specific credit names due to advisory restrictions.

4) Private credit outlook

Skepticism toward private credit persists, albeit with less intensity (reduced media coverage does not imply disappearance). While credit risks (and losses) are present, they are unlikely to become systemic due to relatively low leverage across the financial system. Contagion risks appear therefore limited. Importantly, in my opinion, the asset class remains attractive within a diversified fixed income portfolio. Recent portfolios that I have seen, offer improved terms,

including tighter covenants, higher spreads, and more compelling return profiles. Despite negative headlines and isolated stress events, private credit continues to appeal to investors seeking stable income from a diversified investment approach. We should remain mindful (my point is directed at those who criticize the private debt) of institutional investors' allocation frameworks, their portfolio rebalancing cycles, and the LPs' capital consumption of individual investments. On the other side, it is true that the low volatility and low default rate narratives are increasingly difficult to support given current evidence, yet private debt remains a reliable financing source and an attractive value proposition/alternative for the corporate sector.

5) European CLO market

The European CLO market slowed down in April, particularly following the escalation of tensions in the Middle East. This contrasts with the U.S. market, where activity has continued, albeit at lower volumes. The behavior of the European CLO tranches and their drivers (IG notes on one side, mezzanine papers on the other, BBBs in the "no man's land") within the capital structure remains consistent with my prior observations that I will not rewrite here, and they frequently diverge from views expressed by investors, sell side, and strategists who have a wrong tendency to compare current conditions with previous bouts of volatility and extrapolate conclusions inappropriately.

Notably, the recent assets repricing phase appears to have stabilized. Although the weighted average cost of liabilities has risen above 200 basis points (the less performing platforms print at 220-230bps), the arbitrage environment between assets and liabilities has improved for the first time after many months of compression (the impact on quarterly coupons for the equity will persist throughout 2026 and probably more; bear in mind, however, as a tailwind force the reset and refinancing options as we have recently seen for some CLOs in April). Opportunities for alpha generation and par recovery exist today within the underlying asset pools. Careful vintage selection allows tranches investors to discriminate across issuance years, varying portfolios quality, manager approaches, and between vehicles in and out of their no-call or reinvestment periods. One note of caution relative to prior episodes of volatility (I return to the note's opening line): this time, CLO tranches that appear cheap may remain so, and for justified reasons.

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