

Market View

by Sergio Grasso



Strong and soft Crosscurrents

The last two weeks have been very busy in European leveraged finance, with earnings releases, bonds and loans in primary, the regular repricings, add-ons, new hires within legal and financial teams for companies in distress, and new structured products launched and printed — from CLOs to consumer and auto ABS.

On top of all this, we had Central Bank meetings. The fiscal topic in the United Kingdom closed the circle, as government borrowing figures — ahead of a challenging budget — came in significantly higher than forecasts and expectations. France, in the meantime, has a new Prime Minister, as expected by those close to French politics and used to the political uncertainty often stemming from the “Hexagone”(another way to call France).

Treating all the points would require several pages, and I prefer to be brief this time:

- A. Central banks remain difficult to interpret, both in messaging and in intentions — from the Federal Reserve to the Bank of Japan. Guessing the terminal rate across continents is nearly impossible at this stage. In the case of the Bank of England, there was little news in the minutes, and judging by the market reaction, no change in guidance. The debate in the UK remains centered on cyclical weakness versus structural uncertainty-which pushes for less accommodative monetary policy, with the latter probably dominating the picture.



Bank of Japan left its policy rate unchanged at around 0.5%, in line with expectations, although two policy board members opposed the decision. In a surprise announcement, the BoJ said it would begin selling its holdings of equity ETFs and J-REITs into the market. “Slowly” is the key word: based on the disclosed pace of sales, it would take well over 110 years to fully offload those assets (when signals are more important than facts). As for the European Central Bank, the decision to keep rates on hold was largely a non-event. The ECB, at this moment, appears to have a high threshold for further rate cuts, but that stance may shift depending on whether European current growth levels (not great) will be maintained in the future. Finally, the Federal Reserve: while the 25 bps cut was widely expected, the confusion and dispersion around the Summary of Economic Projections (SEPs) were not. Chair Powell's tone during the press conference came across as more hawkish than both the statement and the projections, leading to visible confusion across markets —particularly in forex (see EUR/USD) and along the Treasury curve (shifting higher in the long tenors).

- B. Investment Grade (IG) and High Yield (HY) cash credit spreads (OAS) in Europe continue to show minimal movement week after week. Year-to-date, they have tightened by approximately 30 basis points. As usual, investors appear to be shrugging off political uncertainty, geopolitical risks, and mixed macroeconomic data. At the micro level, however, we're starting to see some cracks. Several companies have reported their Q2 earnings: on average, revenues have been flat, while EBITDA figures showed clear signs of pressure. EBITDA margins are declining or not improving, and positive cash flow generation is absent in many cases. Additionally, cash interest coverage ratios are, in several instances, falling below 2x.

In certain credits, long-dated liabilities help offset weak performance from a risk perspective. A decent liquidity position combined with access to partially drawn or undrawn revolving credit facility (RCF) currently supports the ability to meet debt obligations. However, in other cases, leverage has reached levels that no longer align with existing credit ratings or with what would be considered viable business models. Working capital management cannot sustainably compensate for cash shortfalls over multiple quarters, and signs of strain are emerging. So, why are we seeing such widespread Q2 weakness? My personal view is that many of the positive tailwinds originated by fears of President Trump policies on tariffs — particularly the frontloading of international trade and inventory buildup — have now faded or work with less intensity. The macro and sector-specific factors that had buoyed European industrial credits have ceased to be significant contributors to revenues 'growth. We know well how the EBITDA adjustments may help with covenant compliance in the SFA, but they do nothing to resolve actual liquidity shortfalls — especially in a high-rate environment where interest expenses remain a significant burden for borrowers.

A separate consideration must be given to French HY names ("Égalité, Fraternité..in stress"), which are significantly underperforming the broader European HY index across multiple sectors. Despite knowing most of these credits well, and after considerable research on latest financial numbers, I still struggle to identify a single common factor behind the underperformance. The weakness in results is not linked to any specific industrial sector, nor does it appear to be a result of recent debt refinancings at high interest rates. Several credits kept the same facilities in place since 2022-2023. Weak domestic demand in France is also not the root cause, as many of these companies generate a decent portion of their revenues internationally.

My best guess is that this underperformance stems from a combination of factors: poor strategic decisions made by private equity firms that acquired companies at unjustifiable multiples and continued their mistakes with more acquisitions and low realization of synergy plans; excessive leverage (at times the consequence, at others the cause) on balance sheets that is increasingly being penalized, which explains why the debt trades in secondary market at double-digit yields; a general convergence of bad timing and misfortune.

Altice France's troubles have proven to be the canary in the coal mine. Brace for more LMEs, creditor-on-creditor violences, litigations, credit downgrades.

Being a minority creditor is not easy in those days.

Now two points on risk/return dynamics:

1. European credits are currently trading excessively tight relative to their underlying fundamentals, and yields should, in time, adjust to reflect this imbalance. Tail risks remain elevated. As I mentioned in a previous post, several recent primary bonds transactions in Europe appear mispriced. Take, for example, Evoke 2031, priced at 8%, and Salt 2030, priced at 3.875%. In my view, these yield levels are too tight given the credit risks and in comparison to peers and benchmarks within the same sectors (I invite to study the credits and the docs).

Leverage loans are mispriced and clustered around the 350 bps margin spread over Euribor. Persistent inflows into risk assets continue to dominate price formation, often distorting the true pricing of credit risk. This dynamic is pushing valuations beyond levels that fundamentals can reasonably justify while credit curve spreads flatten as a result.

Against this backdrop, I continue to expect a moderate, general decompression in yields, accompanied by idiosyncratic volatility in specific names.

This leads to an important question: Why are certain European high-yield credits exhibiting such significant volatility, with prices dropping by several points in a short span of time? Is this only the result of earnings underperformance relative to guidance? Are we seeing the consequences of low earnings quality, where results have been supported by non-recurring adjustments that are no longer sustainable? The sharp price declines appear to be primarily driven by CLOs, which are actively selling positions as part of prudent portfolio and risk management — either to maintain compliance with internal limits or to avoid breaching coverage tests. This selling pressure often results in forced de-risking, triggering sudden downward corrections in debt prices.

The kind of rapid and widespread price declines seen in 2025 are unprecedented in both frequency and intensity — except, perhaps, in isolated past cases involving outright fraud. What we're witnessing now, however, points to deeper systemic fragilities rather than one-off corporate events.

Frequent market nosedives would require lenders and bond investors to rewrite the rules of investing, to revise how the risk is measured and managed, and to verify more often how the assets are allocated in the portfolio; I repeat this concept over and over in my meetings and conversations: "The volatility we perceive stems from deeper, structural issues within the current leveraged finance space— issues that significantly precede concerns over restructuring or default". This isn't about philosophy; it's what's really happening in the European high yield space.

2. Structured products. Aside from the regular activity we continue to see in Europe's primary market for ABS products, I've been observing with growing curiosity and interest a notable trend: an increasing number of new investors are expressing the willingness to enter the asset class. The secondary market volumes reflect this development as well. This growing interest is likely being supported by improving regulatory conditions in Europe—particularly the proposed reforms to Solvency II, which could lead to more favorable capital treatment for securitized products. What's also contributing to this momentum is the increasing familiarity among investors with structured credit (look at the banks for instance).

ABS continues to appear attractive relative to investment-grade and high-yield, especially from a pricing perspective. While such comparisons can be misleading—given the very different risk profiles and structural complexities—investor appetite for ABS has increased markedly in recent months.

I am deliberately steering clear of commentary regarding coupons, DMs, entry points, or particular structures. With spreads having compressed significantly across the board, the traditional spread ratios between tranches and/or products have, as I've noted repeatedly, ceased to provide meaningful indication of relative value. What's particularly surprising is that certain analyses persist in relying on these metrics (another example are the long-run averages), despite mounting evidence that their indicative value has significantly diminished amid current market conditions.

That said, as always, nuance matters. While the senior tranches of ABS deals are largely a matter of price and relative value, the mezzanines and equity tranches demand much deeper scrutiny.

These segments of the capital stack require thorough credit analysis, due diligence on the manager, docs checking, and robust stress-testing frameworks, regardless of whether the underlying portfolios are composed of consumer or auto loans, real estate exposures, or leveraged finance instruments.

Unfortunately, such in-depth risk assessments are not always standard practice as I can confirm from direct experience in the field. Insufficient investors' engagement with credit modelling and portfolio-level risk signals, can obscure the real value/risk of certain tranches and the impact of active management decisions when those are possible. In the CLO market, for example, we are finally seeing the necessary attention being paid to key structural features such as the length of non-call and reinvestment periods, recovery rates and their timing (critically important in structures that become rigid and amortize), prepayments, and amortization schedules (as you can see not only CCCs and OC cushions are important!).

This makes transparency and comprehensive oversight essential, particularly in mezzanine and equity tranches where structural subordination amplifies the risk and no performing asset pools can alter the original IRR expectations established at the time of the investment.

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