The first month of 2026 in European credit

As January draws to a close, it is useful to reflect on the key developments in the European high-yield market. Risk assets have remained broadly constructive, despite elevated fiscal and monetary policies and geopolitical uncertainty spanning the U.S., Europe, and Japan—conditions that would normally be associated with higher volatility and episodic risk-off behavior. Instead, the expected yield decompression failed to materialize. The iTraxx Crossover opened 2026 financial year at 244 basis points and closed January only modestly wider at 248 bps.

Implied credit volatility has compressed sharply, reaching levels likely not seen in more than 15 years. Primary issuance has been strong across both loan and bond markets, but repricing transactions have clearly dominated activity. Loan margins have been reduced in repricing activity by approximately 35-40 bps on average, directly pressuring CLO equity returns. Many bonds priced inside IPTs with little premium over the existing corporate credit curves. Current credit spreads are difficult to defend as sustainable (or protecting the investors if you prefer). Volatility should pick up.

This backdrop is well understood. More interesting, however, are the less visible dynamics shaping the market.

1) Elevated dispersion beneath an apparently calm market

Despite the surface-level stability, dispersion in credit world remains unusually high, extending what was already evident in mid to late 2025. The frequency of large single-name moves has stayed elevated, creating meaningful opportunities-longs and shorts- for alpha generation in credit selection. At the same time, traditional carry trades are becoming increasingly unattractive. Spread levels for certain issuers—particularly B/B2-rated credits inside 300 bps—are difficult to justify on both absolute and relative value grounds. In some bonds recently appeared in primary with fixed coupons the risks are not entirely priced into yield profiles. Corporates with softening operating performances and sectors concerns should require better returns.

One underlying driver of this market behavior is the CLO bid (the other component consists of inflows received by the credit asset class). Persistent and strong demand from existing CLOs and new warehouses ramping portfolios, continues to drive loan and FRN spreads to new tight levels. This trend started in the first quarter of 2024 and it has been undervalued.

Today the convexity is poor: a significant percentage of the mispriced leverage loan market offers limited upside from current price levels- loans at or over 100 are a relevant proportion of available collateral-while retaining downside risk. If I remain focused on analyzing the CLO field, the loans create a structural challenge for "par build" within asset pools, especially given that ABS structures are fundamentally carry vehicles rather than engines of alpha (the European managers who pursued in the past aggressive strategies and quick AUM growth, face today significant challenges).

The convexity remains decent in the bond market (not the floaters) but attractive names are becoming limited with no longer any upside left to squeeze in long trades.

A credit market correction would likely eliminate excess froth, leaving limited places for shelter.

2) Tightening CLO arbitrage and growing stress at the margin

The total weighted average cost of capital for European CLOs has declined to approximately 180–195 bps, down from 205–215 bps at the end of 2025. With asset spreads clustered around 315–325 bps, supported by strong technicals and sustained inflows, CLO arbitrage is increasingly compressed. This dynamic is unlikely to support attractive forward returns for the most subordinated tranche, the equity. This is expected to hold at least through 2026 after a 2025 when "less went right".

Of particular concern in my view are CLO resets executed despite visibly deteriorating portfolio quality—a development that warrants heightened investor scrutiny (A notable feature of 2025, and a confirmation of what I am writing, was that AAAs tranches in resets priced wider than the new-issue papers).

Reset activity remains substantial, both in absolute volume and as a share of the overall European CLO universe. Portfolio liquidations of amortizing CLOs will become complicated for "value extraction" if leverage loan prices will keep drifting downward (the ELLI is getting near the lows of April 2025); this explains the decisions about the latest refinancings (easier to do) and the filed notices of intention to refinance old vintages out of no call period.

As dispersion across managers increases, portfolio management style will matter more: disciplined managers that prepare portfolios for a less forgiving environment—while remaining alert to selective opportunities—should outperform, conversely some CLOs that I monitor risk remaining stuck for an extended period to deeply discounted CCC holdings and exposed to negative consequences of aggressive LMEs. Episodes of creditor-on-creditor conflict around some credit names are likely to persist and those do not bode well for portfolios in structured vehicles that do not have the favor of the time- like a distressed fund- and the weight to influence the outcomes.

3) Relative value across the CLO capital structure

Relative value across the CLO stack remains highly dependent on investor risk appetite and confidence in manager capabilities/execution and credit selection. In my view, the lower tranches in the capital stack are generally expensive, particularly in vehicles whose asset pools are already exposed to obligors under stress. While credit weakness is not yet broad-based, some CLO structures are approaching key limits and tests and beginning to show signs of strain.

Careful positioning is the focus for extracting value even in the tranches trading wide in DM. I recommend identifying the most desirable profiles among CLOs with long reinvestment periods and the ones which kept market value of collateral above safe threshold (this is a very personal metric, it is not the one reported in the docs).

Since the widening of Q4 2025, between September and December, tranche spreads have compressed meaningfully. BBBs are inside 300 bps and BBs inside 500 bps, reflecting significant spread tightening. To keep CLOs appealing to equity investors (AAA tranches are still above 120 bps, roughly where the market was in Q1 2025 but the assets yielded 60-75 bps higher), the structures are lowering coupons on tranches that are either most in demand due to rating appeal (BBBs) or most easily influenced/sought by the retention vehicles managed within the same platforms launching and printing the deals (BBs and Bs). This should compel CLO investors to be increasingly selective, with greater emphasis on vintage differentiation, call and reinvestment periods (more than 50 billion of European CLOs are set to exit the RP- the 2022 vintage is special on its own because it clearly separates the two halves of that year where the WACCs passed from 180-195 bps to 310 bps or more from July onward).

Despite tighter valuations and some tranches trading expensive, selective opportunities remain in both primary and secondary markets for investors willing to underwrite risk with discipline, allowing them to vary exposures and mitigate repercussions should cracks emerge in leveraged credits.

4) CLO ETFs

An increasing number of credit platforms are launching active UCITS ETFs in Europe. Investors often ask whether this trend will continue and if it is worth exploring. My response to institutional managers already active in the CLO space is that the investor base may differ, and the strategies employed can vary across the two main approaches. The product is still young—the first publicly traded CLO ETF was launched in the US in 2020—and has not yet been tested under stressed market conditions. Nevertheless, the CLO ETFs remain an attractive option, as they complement rather than cannibalize existing dedicated funds with tailored investment strategies. I am sure there are no concerns about showing relative performance, isn't there?