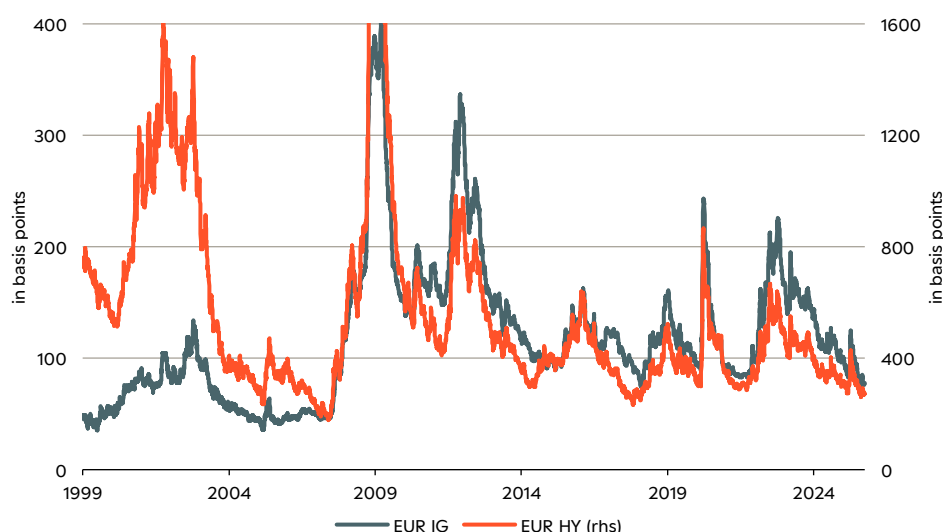


Structural changes favour lower credit spreads

Euro corporate bonds have continued their upward trend in the current year. Their risk premiums, also known as credit spreads, recently fell to the same level as during the European Central Bank's excessive bond purchases during the coronavirus crisis (Fig. 1). Nevertheless, corporate bonds are not necessarily expensive. Changes in the corporate bond market suggest that credit spreads could be structurally lower than in the past. We look at how credit spreads are composed, discuss which macroeconomic aspects could argue for structurally lower credit spreads, and then examine changes in selected market segments.

Fig. 1: Risk premiums on corporate bonds recently in decline

Risk premiums of euro investment grade (IG) and high yield (HY) corporate bonds relative to government bonds hit multi-year lows



Period January 1, 1999 – September 30, 2025

Source: ICE

Risk premiums encompass more than just compensation for default risk

The risk premium is the difference in yield between a risky bond and a risk-free reference interest rate with the same maturity (e.g. a government bond with the highest credit rating or interest rate swap)¹. It reflects compensation for systematic risks such as economic downturns and risk preferences, as well as unsystematic risks such as default risks or rating downgrades of the issuer. Additional factors, such as the capital rank, term and termination rights of the specific bond, also influence the premium. Furthermore, a liquidity premium is taken into account, the amount of which depends on the general risk appetite, liquidity situation on the capital market, and individual factors relating to the issuer or the bond.

¹ An interest rate swap is a financial derivative in which two contracting parties exchange fixed interest payments for variable interest payments on an agreed nominal amount for a specified period of time without transferring the nominal amount. Since standardised interest rate swaps are either secured through a clearing house or subject to bilateral collateral agreements, there is no counterparty risk.

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Credit spreads cover many risks



Are corporate bonds the better credit option?

Government debt rising, companies have stable fundamentals

Government bonds have long been considered a safe benchmark for corporate bonds. However, with rising government debt (Fig. 2) and increasing rating pressure, the picture has changed: today, Germany is the only G7 country to be awarded the top AAA rating by all rating agencies. Growing fiscal burdens, such as social spending, infrastructure and defence, are exacerbating the situation, causing investors to demand increasingly higher returns for sovereign risk. Already today, for example, just under 10% of French investment-grade corporate bonds yield less than French government bonds with the same maturity, and they are thus considered to have a stronger credit rating than the French government.

The credit ratings of many countries have deteriorated in recent years

Since companies are subject to regular reporting requirements, this disciplines them to ensure that their data does not become too clouded, as otherwise they face higher capital costs due to rising risk premiums on the capital market. There is also the risk of poorer ratings from rating agencies. Higher capital costs are likely to have a negative impact on profitability and competitiveness, which is why companies are encouraged to pursue sound business policies.

Companies offer stable credit quality

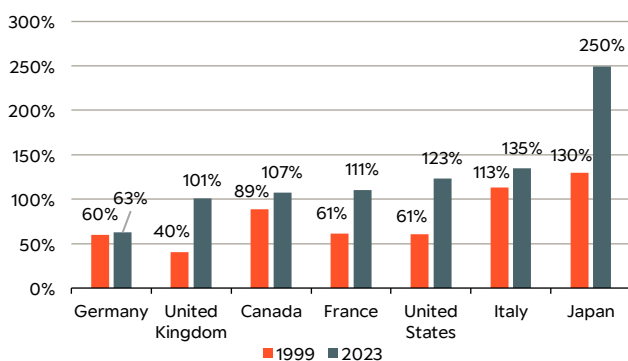
Expansive government spending reduces the risk of corporate defaults

Ideally, debt-financed government spending stimulates growth, but at the same time it drives inflation and complicates monetary policy, as key interest rate hikes would lead to higher interest burdens and further government debt (fiscal dominance). The ongoing fiscal stimulus reduces the risks of a (nominal) recession and thus provides companies with greater planning security, more stable profits, less cyclicity in business models and lower default risks. Inflation driven by government spending could also reduce companies' nominal debt. In an environment of rising government debt, corporate bonds therefore appear to be an increasingly safe investment, which argues for structurally lower credit spreads compared to government bonds. They also allow investors to diversify risk much more broadly in their portfolios than with a limited number of government bond issuers.

Central banks caught between rising inflation and debt sustainability

Fig. 2: Government debt has risen significantly since the beginning of the millennium

Development of government debt in the G7 countries measured against gross domestic product

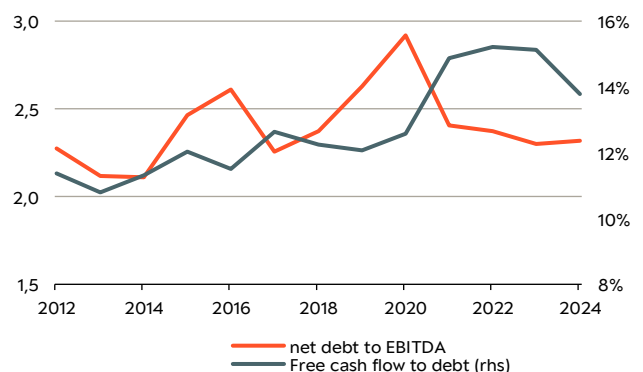


Period: December 31, 1999 / December 31, 2023

Source: IMF

Fig. 3: Companies, on the other hand, show stable development in their debt ratios

Average net debt to EBITDA and free cash flow to debt of companies measured by the ICE Euro Corporate Index



Period: December 31, 2014 – December 31, 2024

Source: own calculations



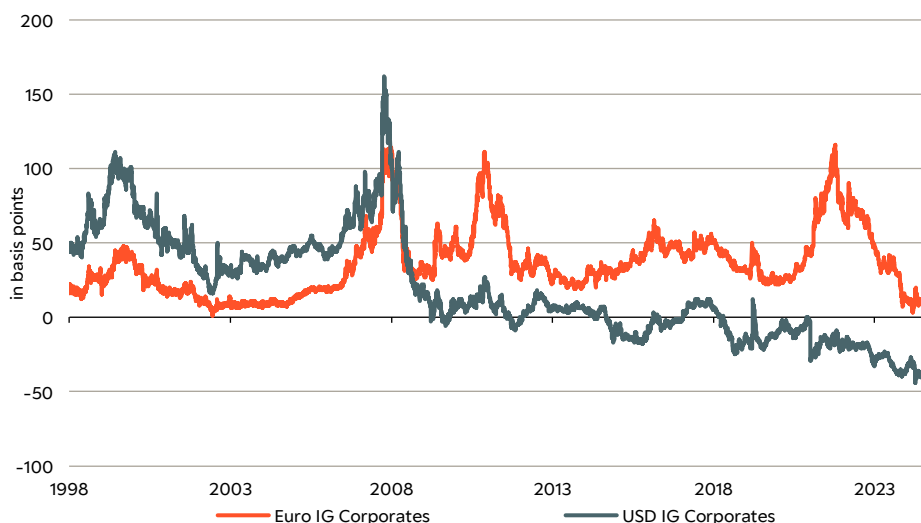
Interest rate swaps as an alternative benchmark

In the US, it has been observed for some time that the difference between swap rates and the yields on US government bonds, which are considered safe, is not only narrowing but in some cases even turning negative. This shows that US Treasuries are now pricing in a risk premium, as is otherwise customary for riskier bond segments (Fig. 4). No clear trend has emerged in Europe as yet, although similar tendencies have been evident recently, at least since the announcement of the German infrastructure package and the adjustment of the debt brake for defence spending. However, it is questionable whether interest rate swaps are now the better reference interest rate. This is because interest rate swaps are mainly used for interest rate management and therefore sometimes react differently to market forces than corporate or government bonds. After the end of the ECB's expansionary policy, for example, swap yields rose more sharply than those of German government bonds in 2022-2023. In order to reduce duration risks and protect against rising interest rates, there was excess demand for hedging transactions at that time, which caused their yields to rise above average. Although many market participants in Europe already prefer swap rates as a reference interest rate, this example shows that they are not a perfect reference interest rate either.

Investors are increasingly turning to interest rate swaps as a reference rate

Fig. 4: Swap spreads show that credit risk for countries is already being priced in

Implicit swap spreads calculated from the difference between credit spreads and interest rate swaps and government bonds for euro and USD IG corporate bonds



Period: December 31, 1998 – September 30, 2025

Source: ICE, own calculations

Returns are the main focus – the re-emergence of return-oriented strategies is influencing market structure and demand

With yields rising in recent years, strategies offering returns well above money market rates are back in investors' focus. Term funds in particular are experiencing a renaissance, as they are seen as an alternative to time deposits or individual bonds, offer predictable returns over the term (Fig. 6) and once again generate returns above long-term inflation. Inflows into this segment are likely to continue as long as yields remain attractive and enable real capital growth. Spread investors, on the other hand, are focusing more on risk premiums, which is currently leading to significantly different assessments of attractiveness, and not only for euro IG bonds (Fig. 5).

The renaissance of fixed-term funds is driving demand for short- to medium-term bonds

The high demand for yield-oriented products is increasingly shaping companies' issuance behaviour and is particularly evident in investment-grade indices. In euro indices, the proportion of short-term bonds has risen from below 50% to almost 60% since the end

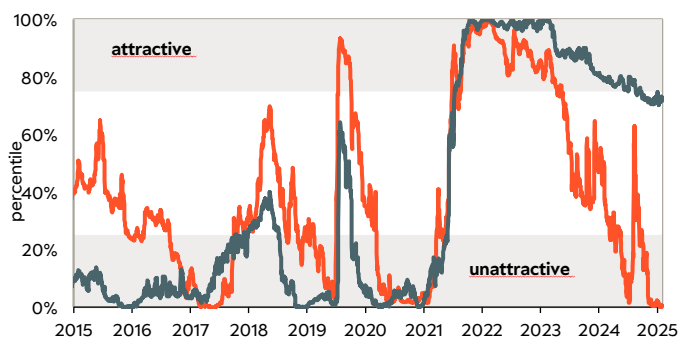
Issuers respond to changing demand



of 2020, driven in part by strong demand from fixed-term funds and other yield-oriented strategies. Longer-term bonds are therefore on the decline. This is probably also because the ECB is no longer acting as a buyer with no preference for maturity, and issuers are therefore once again responding more strongly to investor needs. As long as demand for yield-oriented strategies continues, the risk of significant spread widening should remain manageable, even if their current valuation appears unattractive.

Fig. 5: Yields remain attractive, but credit spreads relative to government bonds do not

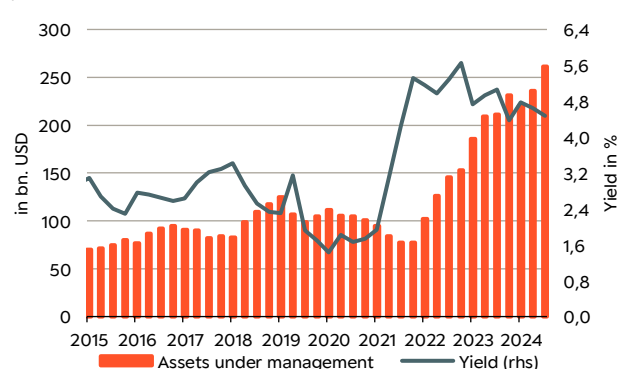
Development of 10-year rolling percentiles² of returns and risk premiums for euro IG corporate bonds



Period: December 31, 2015 – September 30, 2025
Source: ICE, own calculations

Fig. 6: Higher returns give term funds new impetus

Performance of assets under management in fixed-term funds in USD compared to the yield on global IG corporate bonds



Period: January 1, 2016 – June 30, 2025, quarterly closing prices
Source: Morningstar, ICE

The structure of the high-yield segment has changed

While current valuations in the investment-grade segment have been driven primarily by the change in yield levels and new investor segments, longer-term trends are emerging in the high-yield segment that could point to structurally lower risk premiums, as follows.

The proportion of secured bonds has risen to over a third of the total market (Fig. 7). Since secured bonds are backed by specific assets, such as real estate or receivables, in the event of insolvency, their recovery rate is generally higher than that of unsecured or subordinated bonds, reducing the risk of loss for investors.

In addition, the maturity structure of the euro high-yield market has changed and has been developing into a short-duration segment for years. The effective duration³ of euro high-yield bonds has fallen from 4.6 years to currently less than 3 years over the last 25 years. Since the probability of default is lower for shorter maturities, this structurally justifies lower credit spreads.

The outstanding nominal volume in the investment-grade segment has more than doubled since the beginning of 2015, whereas, in the high-yield segment, there has been little growth after a temporary increase during the coronavirus crisis. Since the beginning of 2022, this segment has even been shrinking (Fig. 8). In addition to traditional bonds and bank loans, other sources of financing have become established in recent years for companies in the high-yield segment, such as private debt funds and the leveraged loan market. At the same time, demand is rising – for example, through yield-oriented strategies such as term funds.

Structural changes could argue for lower credit spreads

Collateralisation leads to lower losses in the event of insolvency

The lower-duration risk reduces the probability of default

Rising demand meets a shrinking market segment

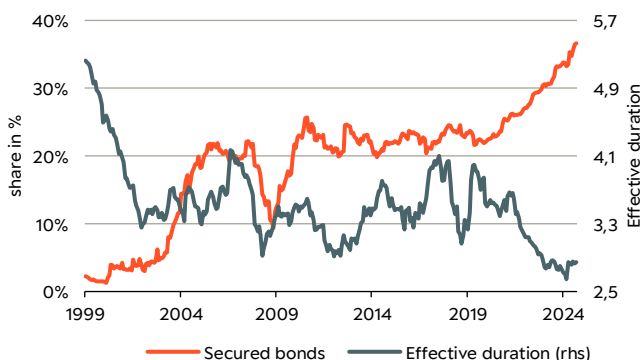
² The percentile indicates what percentage of the entire set of values is less than or equal to the observed value.

³ Effective duration is a measure of risk that quantifies the sensitivity of the price of a bond or bond portfolio with embedded options to changes in interest rates.



Fig. 7: The proportion of secured bonds has risen significantly, whereas duration has fallen

Development of the proportion of secured bonds and effective duration in the euro HY market

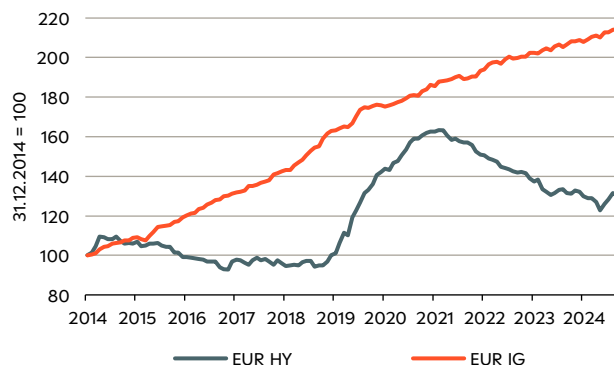


Period: December 31, 1999 – September 30, 2025

Source: ICE

Fig. 8: The high-yield segment has been shrinking since the beginning of 2022, while the investment-grade segment is growing

Indexed development of the outstanding nominal volume of euro HY bonds compared to the investment-grade segment



Period: December 31, 2014 – September 30, 2025

Source: ICE, own calculations

Banks with better capitalisation but without a government lifeline

Until the global financial crisis, the risk premiums on European bank bonds were lower than those on industrial companies (Fig. 9). One reason for this was confidence in government bailouts ("too big to fail"). During the financial crisis, governments did intervene, but only after the collapse of Lehman Brothers, which revealed the vulnerability of the system. In order to avoid further government bailouts and make the banking sector more stable and resilient, Basel III and Basel IV tightened capital and liquidity requirements for banks and established resolution mechanisms. In addition, AT1 (Additional Tier 1) bonds created a new subordinated segment designed to strengthen and supplement core capital.

Banks are now much better capitalised than before the financial market crisis (Fig. 10). In addition, new key figures for bank management have been established to limit high levels of debt and ensure the liquidity of banks. To identify weaknesses, regular stress tests are also carried out by the supervisory authority.

Another relevant question is whether governments and/or central banks will continue to intervene to rescue banks in the future. The collapse of Credit Suisse in 2023 provided an initial indication that they will continue to provide support in the event of a crisis: following a massive loss of confidence, the Swiss banking regulator FINMA declared the bank unviable and ordered its takeover by UBS. The government and central bank supported the process with extensive guarantees, while resolution plans remained unused. Apart from AT1 investors, creditors and even shareholders were largely spared. The case shows that governments will continue to intervene when financial market stability appears to be threatened. However, it remains unclear when they will intervene and which creditor classes will be included in future bailouts.

With growing government debt, governments are seeking new sales channels for bonds. This creates the risk that further regulations will follow that could oblige banks to hold additional government bond holdings on their balance sheets. The US banking regulator has already proposed relaxed capital requirements for large banks to allow for higher government bond holdings. In addition, stablecoins⁴ must now be fully

"Too big to fail" no longer applies, or does it?

States are not exempt from liability

In search of new sales markets

⁴ Stablecoins are cryptocurrencies whose value is linked to and reflects the performance of certain assets.



backed by US government bonds (GENIUS Act). However, the consequences for banks are not clear-cut: higher government bond yields initially increase interest income and support profitability; at the same time, however, their overall exposure is growing in an environment of declining government credit ratings. This could prove problematic in the long term if confidence in the debt sustainability of governments continues to decline.

Furthermore, stricter capital requirements leave banks with little room for excessively shareholder-friendly and risk-prone business policies, as was the case before the financial market crisis. This is positive for senior bondholders, as banks with a more defensive positioning are less vulnerable to economic shocks. Subordinated capital is also likely to benefit, as banks are better capitalised and financial market supervision is likely to be stricter and intervention earlier.

Stricter regulation reduces the risk for creditors

Most recently, the creation of clear market standards for AT1 bonds following the financial market crisis, in which there were a variety of different structures for subordinated bonds, has led to greater transparency. The new standards contain clear rules on the circumstances under which coupons may be paid and the capital ratio thresholds that trigger conversion into equity or write-offs. They reduce complexity and increase transparency. This also makes it easier for investors to analyse and make investment decisions, leading to the further establishment of the AT1 market. This results in greater demand and, consequently, higher market liquidity, thus justifying structurally lower risk premiums in the AT1 segment.

Market standards create transparency

Fig. 9: Financial bonds since 2007, mostly with higher-risk premiums compared to industrial companies

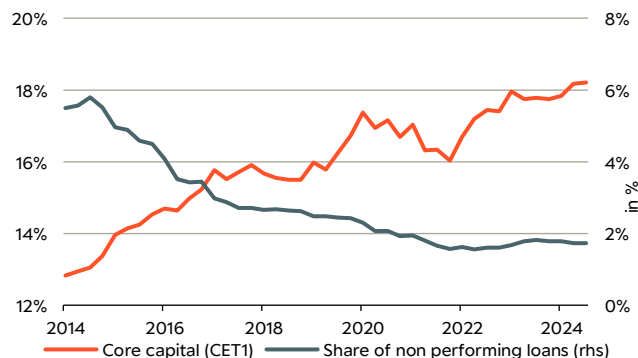
Yield difference between euro IG financial and industrial bonds



Period: December 31, 1999 – September 30, 2025
Source: ICE, own calculations

Fig. 10: The credit quality of banks has improved significantly in recent years

Development of the median Common Equity Tier 1 (CET1) ratio and the share of non-performing loans of banks in the euro area



Period: December 31, 2014 – June 30, 2025
Source: EBA



Conclusion

There are many factors that point to structurally low credit spreads relative to government bonds in individual market segments. The market structure in the high-yield segment has changed. The proportion of secured bonds has risen, while duration has fallen. In the case of financial bonds, stricter capital and liquidity requirements protect creditors, although banks may be forced to hold more government bonds in the future as credit ratings decline. In addition, standardisation in the AT1 segment ensures transparency and comparability. Furthermore, the environment of fiscal stimulus and rising government debt reduces the risk of a (nominal) recession, which, like increased inflation, lowers the default risk of corporate bonds. On the other hand, rising government debt reduces the creditworthiness of countries, and investors are likely to demand higher government bond yields. Even if credit spreads currently appear historically unattractive, investors are likely to continue to prefer corporate bonds in the long term. Their financial ratios are stable in the long term and they also offer greater diversification opportunities than government bonds.

The analysis and selection of corporate and financial bonds is one of our core areas of expertise at Berenberg. They account for a large proportion of our investments in our mutual funds. With Berenberg Euro IG Credit, investors benefit from attractive returns on European corporate bonds with investment-grade ratings. For investors interested in the performance of financial bonds, the Berenberg Financial Bonds fund, which also invests in the AT1 segment and in insurance subordinates, is a suitable option. With Berenberg Euro Target 2028 and Berenberg Euro Target 2030, there are also two fixed-term funds to choose from. In the future, the Berenberg Euro High Yield fund will expand its product range to include the attractive market segment of high-yield bonds.



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