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# Anticipation to Reality: Credit Markets for European Insurers in 2025

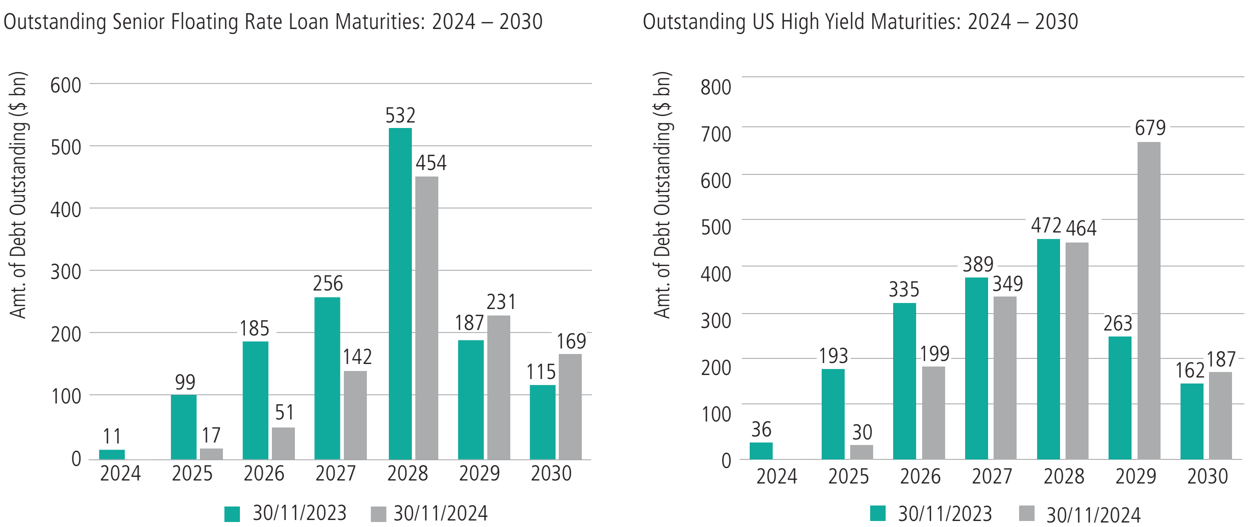
After a year of elections and peak central bank rates in 2024, fixed income investors are likely to spend 2025 digesting the changed policy background and the potential for monetary-policy divergence. Major policy initiatives are already in the works that will affect growth outlooks, most obviously from the incoming US administration, but also across markets from the UK to China.

The balance between supporting growth and containing fiscal concerns will likely be the most important driver of risk-free rates globally. Similarly, while credit fundamentals remain resilient, noting the length of the cycle, spreads remain on the tight end of the spectrum. They could widen depending on the degree of growth concern, but yields would likely offset this move. We see a strong case for seeking additional spread in high grade extended and private credit markets to support income and benefit from stronger investor protections.

In the wake of a rate-hiking cycle, one might normally expect spread widening, credit stress and an uptick in default activity as tighter policy impedes growth and activity. These trends tend to be expressed through lower quality sectors at first, given their leverage and risk profile. As we have seen over recent months, however, this time around the non-investment grade market has something different in mind.

Leverage trends have been moderate and the quality of the non-investment grade market is at an historical high. Balance sheet flexibility remains strong, with debt maturities over the next 12 to 24 months quite low (figure 1). All of this is keeping a lid on default expectations, with less than 2% of the ICE BofA US High Yield Index trading below a dollar price of $70, as at 30 November 2024. That said, one reason traditional defaults have been low is that some deleveraging has been achieved, at the expense of both secured and unsecured investors, via liability management exercises (LME), resulting in more idiosyncratic stress events. We expect issuers to continue to use LME to manage capital structures while avoiding traditional defaults.

**FIGURE 1. NON-INVESTMENT GRADE DEBT MATURITIES HAVE BEEN PUSHED OUT TO 2028 – 29**




Source: Bloomberg. Indices used: Morningstar/LSTA Leveraged Loan Index (left); ICE BofA US High Yield Index (right). Data as at 30 November 2024.

The European market has a similar profile with regard to market stress and default expectations, but it faces the prospect of slower growth and increasing maturities beginning in 2026. Slowing growth means nominal yields are less attractive than in other markets, even taking account of US dollar hedging costs, but it also has the potential to create interesting investment opportunities via rising spread volatility. By contrast, we think resilient fundamentals and a lack of any need for large scale liquidity will limit relative value opportunities among US investment grade issuers, even as yields are likely to remain at recent levels.

## The Policy Backdrop

In the US, all indications are for reduced regulation under the incoming administration, backed by strong market conditions and secular changes to the business environment. We think this will lead to the kind of aggressive strategic actions not seen since late 2019. As such, consensus is growing that 2025 will see a pickup in M&A. With valuations more of a hurdle than access to financing, we think higher quality issuers with room in their credit rating to do so are likely to increase leverage. We see a likelihood of heightened M&A activity in the Healthcare, Consumer and Cable/Media sectors, along with some more idiosyncratic activity among certain Financials and Industrial issuers.

Trade and tariff concerns may have more impact and become more of a focus outside of the US, particularly with the political challenges in Germany, France and the UK, and the eurozone having become increasingly reliant on the US for export demand.

## Positioning Ideas for 2025

With so much policy impact yet to be felt by the global market, we think diversification, especially of credit risk, is an important priority. Notably, this time around investors do not have to abandon quality to achieve attractive yields. At the same time, we recognize that investors—and insurers specifically—have given up liquidity to achieve those yields over recent years, specifically in direct lending and other private markets.  Any shifts away from the more traditional "core" public investment grade markets should take liquidity and quality into account, in our view, but we see a number of areas that continue to offer value and which we think can hold up well through the growth and policy changes likely to play out through 2025 and beyond.

**Asset-Based Lending.** Traditional Asset Backed and Commercial Mortgage Backed Securities (ABS and CMBS), even those that are AAA rated, have been a challenge for Solvency II-regulated investors. However, there are opportunities in Asset-Based Lending (ABL) markets, where first-lien loan exposures that carry attractive capital charges under Solvency II also provide diversification away from the corporate credit exposures that characterize the first-lien direct lending that many insurers already have in their portfolios.

For example, yields in Residential Transitional Lending (RTL), development lending and bridge lending currently start at around 7.5% and can stretch into the mid-teens. These loans often benefit from a strong return on regulatory capital, and when they are made against owner-occupied properties, they can benefit from an LTV-based risk assessment that can improve capital efficiency further. These types of loans are backed by high quality borrowers, with an average life of less than two years, and we see significant demand trends underpinning the market. In terms of credit risk relative to yield and capital consumption, we think this compares favorably to the lower quality direct lending that many investors have poured capital into for years.

**Private Placements.** The private placement market has been a cornerstone of insurance investment for decades. Already more than $1tn in size, its growth has been stronger of late as issuers favor certainty and variety of capital sourcing. This market covers corporate credit, ABL, project finance and infrastructure, and credit tenant leasing. Its close cousin, the European loan market, also offers diversification opportunities in the form of lending to strong, mid-market private companies that have traditionally raised capital from the private loan market.

In exchange for giving up a modest degree of liquidity, spreads available from these markets have remained relatively attractive through a period of compression in public markets: 75 to 300 basis points of additional spread is available over public issues of similar quality and duration, notwithstanding covenants and structural protections that do not exist in the public market. Issuers want flexibility, variety and certainty in their sources of capital, given the likely imminent changes in the policy, regulatory and M&A environment, and for that reason we expect private placement and European private loan issuance to remain at their current high levels.

**Extended Public Fixed Income Sectors.** In our view, the recent impact of higher rates on sectors such as Agency Residential Mortgage Backed Securities (RMBS) creates opportunities for global insurance investors in 2025. Historically, the negative convexity and the challenges of hedging prepayment risk have limited opportunities for non-US investors, even though the quality and short duration of the sector make it attractive under Solvency II. Today, given dollar prices are at or below par, the risks of prepayment are diminished, as the bonds would pay off at par, leaving investors with some degree of reinvestment risk but almost no credit risk, given the Agency support of the market. Lower-coupon Agency RMBS are viewed as fairly well insulated against prepayment risk, regardless of trends in the fed funds rate.

## Conclusion: Exchanging Liquidity for Spread

The dynamics underpinning the current, protracted credit cycle remain entrenched and continue to influence market valuations. The prospect of an economic slowdown and a coordinated shift in monetary policy seem less likely, while fiscal trends appear likely to continue to drive yields in the near term.

We remain sanguine about defaults and credit stress in 2025, but we do expect more M&A, and this could drive the market into the next phase of the credit cycle. Given the starting point for valuations, we continue to emphasize diversification away from public investment grade credit and into high grade extended and private markets, where possible. Here, we see unique carry opportunities that are more likely to be insulated from the shifts we expect in public high grade credit markets—shifts that have been building for some time but which look set to come to a head in 2025. The US market looks more attractive from a growth perspective, but US dollar public credit valuations are frustratingly tight; we therefore see more compelling opportunities among private placements, first-lien ABL and other extended high grade fixed income sectors.

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