European ABS 2025: Income will remain king

January 2025

Given modest interest rate cut projections, a stable if not stellar macro backdrop and better relative value than corporate credit, we think European ABS investors can expect another strong year of supply and returns in 2025.

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Key takeaways

- We expect 2024's record supply across European ABS and CLOs to be matched in 2025 as a stable macro backdrop spurs lending.
- Slower rate cuts are a tailwind for the largely floating rate European ABS market, whose income will be crucial to total returns with limited potential for more spread tightening.
- AAA notes, CLO mezzanine bonds and the growing opportunity in asset-backed finance (ABF) are our top value picks for 2025.

Credit markets saw strong performance across the board in 2024 as investors shrugged off a slower pace of interest rate cuts and took their lead from a string of stable global macroeconomic indicators.

With higher rates boosting the floating rate income of European ABS and bullish sentiment driving additional spread performance, the asset class once again enjoyed some of the strongest returns across global fixed income.

Before giving our outlook for 2025, it is worth looking back on the factors that drove record supply and healthy returns in 2024.

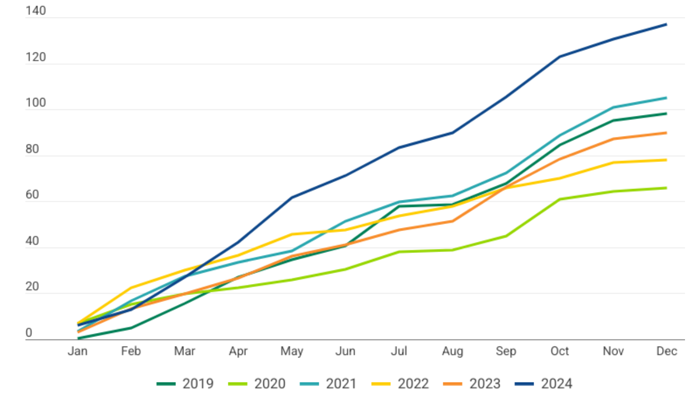
Supply met growing demand in 2024

European ABS investors enjoyed a strong 2024 as higher rates drove income returns and the stable macro backdrop fed through to impressive deal performance, the latter ahead of our own expectations.

Coming into the year we had expected higher rates to impact lending volumes to households and corporates, but resilient economic data and the acceptance that peak rates had passed saw credit demand and supply rebound moderately. We saw a uniform improvement across consumer and business confidence surveys and barometers such as UK mortgage approvals, which were at 68k in November 2024 having hit a low of 40k in January 2023.

Coupled with lenders looking to diversify their funding in a post-QE world, this more positive sentiment drove a marked increase in primary ABS issuance, with €137bn in total supply easily surpassing the previous post-2008 record of €107bn in 2021.

Exhibit 1: Cumulative European ABS issuance



Note: For previous years, the numbers correspond to end of month readings.
Source: Concept ABS, Bloomberg, Morgan Stanley Research

Collateralised loan obligations (CLOs) contributed some €48bn of the total, thanks to a combination of leveraged loan supply returning and loans being refinanced, which prompted a surge in CLO refinancings. We saw more from Italy and Spain across consumer ABS, a welcome new source of diversification and an attractively valued one in our view given stable performance in recent years. ESG focused deals also increased by around 50% from a low base to €4.2bn.

European ABS welcomed 15 new issuers (excluding CLOs) in 2024, compared with eight in 2023. The UK retained its crown as the most dynamic geography by providing the vast majority of those newcomers, though notable exceptions were a Portuguese debut credit card ABS and a first solar ABS from Enpal out of Germany which saw heavy interest.

Significantly, the private ABS markets also gathered momentum in 2024 under the now widely used banner of asset-backed finance (ABF). While by no means a new market, growth has accelerated in response to anticipated regulatory changes and a desire by banks and lenders to build resilience through alternative sources of capital and funding. This in turn increases resilience and flexibility for the European economy, a key policy objective of the regulators. One key component of ABF that made plenty of headlines was the Significant Risk Transfer (SRT) market, which enjoyed a record year with an estimated €30-35bn of supply.

Positive macro backdrop remains

The resilience of consumers and corporates was impressive in 2024, and we expect this trend to continue as moderating inflation, easing interest rate pressures and low but positive growth provide a broadly benign environment.

We do expect a gradual deterioration in consumer and corporate credit fundamentals to be a continuing theme for European ABS in 2025. However, slow, measured declines in asset performance are typically easily absorbed by the excess cashflows built into ABS transactions, which makes us confident we will not see an emergence of defaults or losses.

To illustrate this, the negligible increases in unemployment forecast for the UK (4.5% by year-end from 4.3% now) and the Eurozone (6.5% by year-end from 6.4% now) are not a concern for investors or central banks. In fact, we see headroom for them to materially underperform these forecasts without an impact on the asset class. However, we continue to feel that such an environment favours prime consumers, and that weakness will show itself through less resilient pockets such as lending to marginal consumers and the very limited non-prime ABS markets that exist in Europe. On the corporate side, default rates should remain in check, with the ability to access liquidity a continuing mitigant to maturity risks for all but the most problematic businesses. This should mean default cases remain mostly idiosyncratic and with few obvious cyclical problem areas.

As our 2025 fixed income outlook highlighted, we have seen an increase in tail risks that remain a threat to our core outlook. Geopolitical risks have spread and we believe are being neglected by markets, while the incoming US administration's trade policy is a material source of uncertainty. With equity market valuations stretched and spreads in many corporate bond sectors at fresh tights, these risks carry more potential to trigger sharp corrections.

Interest rates a tailwind for ABS

In our view, over the course of 2024 central banks moved from "data dependent" (which cynics might translate as "playing for time") to a clearer position heading into 2025.

With the Eurozone and UK economies having found reasonable balance and core inflation stubbornly trending above target, the European Central Bank (ECB) and Bank of England (BoE) can afford to be more patient with rates. While we expect 100-125bp of rate cuts from the ECB in 2025, our wider forecast of 50-125bp of cuts from the BoE reflects the greater uncertainty here; at the conservative end these forecasts would leave Eurozone and UK base rates at 2.00% and 4.25%, respectively, by the end of 2025.

With these elevated rates keeping the floating rate income available in European ABS higher for longer, we believe the asset class looks fundamentally attractive (we discuss our outlook for spreads over these levels below). Furthermore, if rate cuts are well managed and understood, it creates a more certain environment for lending and corporate dealmaking. This will provide the backdrop for European ABS issuance to consolidate its bumper year in both consumer and corporate deals.

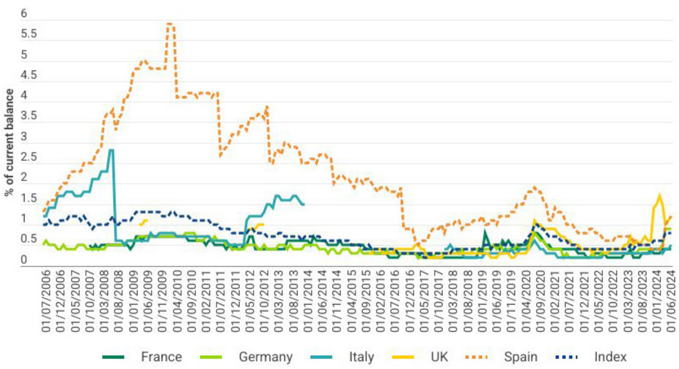
Mild performance deterioration expected

ABS asset pool performance has weakened, but from a very strong base; of all the established European ABS markets, it is only UK buy-to-let residential mortgage-backed securities (RMBS) and non-conforming RMBS where loan arrears are above their 10-year averages – this we think is partly a consequence of seasoning in these markets and a response to higher interest rates creating payment difficulties for certain borrowers. Asset performance in more typical bank-originated Prime RMBS transactions has shown little impact from higher interest rates across Europe.

The recent stabilisation and then fall in interest rates is limiting further deterioration within RMBS deals and in some cases giving sufficient relief to reduce delinquency buckets. Deutsche Bank analysts recently noted the decreasing proportion of RMBS deals with deteriorating performance when compared to 2022 and 2023, the period when the impact of inflation and increasing rates was felt most sharply. One observation from our recent due diligence engagements is that the pressure on lenders from European regulators post-Covid to provide relief to struggling borrowers is creating a bulge in arrears but with very few resulting defaults. This is distorting deal performance, but it also suggests lenders (and ABS deals) are sitting on low-risk loan portfolios and often receiving partial payments, allowing them to take a more patient approach to non-performing loans.

Auto and consumer ABS performance has deteriorated modestly, but across Europe the difference here compared to mortgages generally reflects the more "prime" nature of homeowners. We expect performance to stabilise around these more "normalised" levels in 2025. We note that Italian and Spanish consumer ABS performance has universally outstripped the German equivalent, a reflection of the recent difficulties faced by the German economy. It is also worth highlighting that consumer ABS offers investors downside mitigation in a slightly differently manner to RMBS, primarily through being short in nature (deleveraging reduces credit risk) and having generally higher cashflow coverage.

Exhibit 2: Auto ABS 60-day arrears by geography



Source: Deutsche Bank, 1 January 2025.

The majority of recent noise and negative headlines around European ABS have concerned commercial mortgage-backed securities (CMBS), as the commercial real estate (CRE) market continues to find its feet in the higher rate environment. CMBS is a small market in Europe, and we continue to be positively surprised by its relatively low level of poor outcomes. Reflecting changing property valuations, downgrades paint a picture of concern for the sector; despite being only 5% of the European ABS market, CMBS accounted for 31% of total downgrades in 2024. There may be a case for new CRE lending to commence in 2025, though we remain cautious on CMBS and would target loans used to acquire properties where we think valuations are a true reflection of price, as opposed to refinancings.

A special mention for CLOs

The global CLO market saw almost $203bn of new issuance and $291bn of refinancings in 2024 – a post-2008 record – as pricing conditions improved for the duration of the year.

The emergence of a distinct $250bn market for US middle market CLOs continued apace, amid the unstoppable growth of the now $1.7tr global private credit market. We saw a first middle market

CLO issued in Europe by Barings in Q4 2024, and we expect others to follow this path in 2025.

In the absence of material M&A activity in 2024, new leveraged loan production was low, leaving refinancings to drive new CLO production. We expect that balance will change in the coming quarters as stable growth and lower (especially euro) interest rates will slowly spur greater M&A activity and be one major contributor to CLO volumes remaining close to 2024's record levels.

The combination of deal performance and deleveraging across global CLOs in 2024 was reflected in ratings actions, with 944 upgrades against 90 downgrades over the year. It is also keeping CCC loan defaults in both European and US CLOs below long-term levels. In fact, Fitch data shows the proportion of CCC rated loans held within European CLOs at the end of 2024 was 4.6%, comfortably below the 2021 peak of 6.6%. The refinancing of loans has also helped to address the potentially problematic maturity wall, with holdings of 2026-maturity loans now down to 6% having been 17% at the end of 2023.

The CLO market remains a core allocation for us, and with an increasingly global investor base, liquidity continues to improve. We see risks in some older, more weakly-managed deals unable to reinvest with underperforming loan portfolios, and we will also keep an eye on leverage increasing in new deals as terms get better. Deregulation for US banks and renewed interest from Japanese banks should further increase demand for AAAs globally. With the opportunity to use both the US and European markets, as well as new managers and vintages to improve diversification within CLO allocations, we remain constructive on CLOs for 2025.

Developing ABF market

As mentioned above, ABF now represents a growing European and global opportunity to acquire exposure to consumer, corporate and other esoteric asset portfolios as lenders seek to evolve their business strategies and respond to regulatory changes. We expect to see more capital raised in this space, along with broadening opportunities to deploy it. ABF has become an evolutionary step for many private debt investors seeking diversification from material direct lending allocations, with the notable potential benefit of increasing spread over risk-free rates from 5-7% to 10-12%.

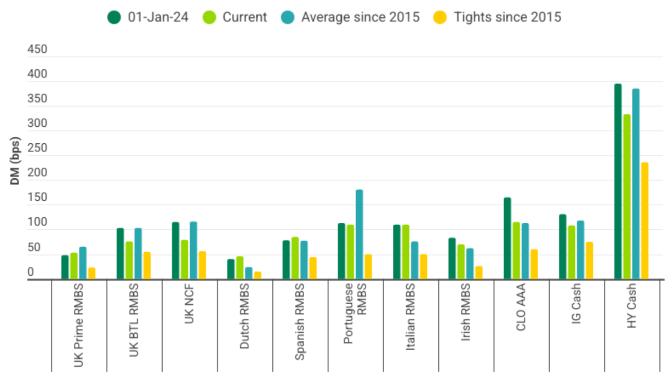
This growth is underpinned by the same supportive backdrop that is benefiting ABS more broadly, providing stable cashflow. In Europe the ABF opportunity is also supported by stable and conservative lending standards, which gives us greater confidence on credit risk over the long-term.

Better relative value than corporate credit

Since 2022, spreads in European ABS have been tightening pretty much continuously. The trend was more modest in 2024 than in 2023, however, and in the latter part of the year that pace slowed further. The market looks much more balanced as it enters 2025 in our view, with some potential for tightening in CLO AAA and mezzanine bonds but less potential elsewhere. In contrast to corporate credit markets such as high yield bonds, European ABS and CLO spreads in percentile terms remain relatively wide of the post-2008 tights achieved in 2015 (see Exhibit 3).

We also see the growing market offering investors greater certainty both in terms of supply from regular issuers and the availability of trading desk inventory for competitive secondary market opportunities.

Exhibit 3: European ABS and CLO spreads versus tights



Source: Deutsche Bank, 1 January 2025.

Our top three picks

Given reasonable valuations overall, there are three areas we think will offer investors value in 2025.

The first is AAA notes. Take your pick on the sector, but high rates and an uncomfortable compression in corporate bond spreads make AAA European ABS bonds look even stronger in our view. AAAs are credit risk remote and can be turned over in large volumes at low cost, adding additional value in terms of trading alpha potential for active investors. A few current pricing examples to highlight the point would be:

- 5yr Prime UK RMBS at Sonia+52bp (5.25% yield in GBP)
- 3yr Australian RMBS at BBSW+115bp (+103bp or 5.76% yield in GBP)
- 5yr European CLO at Euribor+130bp (+135bp or 6.08% yield in GBP)
- 3yr German consumer ABS at Euribor+70bp (+75bp or 5.48% in GBP)

Next is European CLO mezzanine bonds (again). We mention this category frequently, but as the years go on the spread premium we see remains and the track record builds. Globally, CLO spreads rallied materially in 2024 and the discounts to par and convexity opportunity has gone for now, so carry will be key in 2025 and CLO mezz offers more of that than anything else in the major European ABS markets. BBBs at 300-350bp, BBs at 575-650bp and Bs at 875-1000bp remain compelling in our view.

Third is ABF deals. Away from the public markets, Europe is an increasingly sought-after market for private credit investors. It is less competitive than the US, opportunities for alternative capital providers are growing, and for teams with experience it is a source of potentially double-digit spread returns or mid-teen yields.

Taken collectively, we think opportunities at both ends of the credit risk spectrum in European ABS look compelling for investors in 2025.

Income will remain king

If geopolitical headwinds can be skirted once again in 2025, then we see three factors that bode well for European ABS.

Credit resilience – Balanced economic growth should facilitate continued robust credit fundamentals across both households and corporates, supporting ABS asset performance.

Consolidated market growth – We expect continued growth in public ABS and private ABF as the stable macro backdrop allows growth in the demand for and supply of lending. We think the public European ABS market could provide around €140bn of new supply in 2025, with Australian ABS adding a further AUD70-80bn.

Rangebound spreads – With strong and stable supply, we expect investor interest in European ABS will keep pace with yields and low volatility being strong pull factors. We expect limited movement in spreads overall across the full year, which means we think investors can expect to achieve the elevated yields on offer in the asset class.

As always, it is important to ask what can go wrong. What are the risks to our core outlook? Tail risks are certainly elevated – particularly on the geopolitical front in our view – and after a period of stability and strong performance across most risk assets there is potential for sharper reactions to new developments. For ABS investors, we believe these risks can be managed by limiting forays into known cyclical assets that exhibit non-prime characteristics, or into issuers with less experience maintaining higher quality credit profiles overall. We continue to feel that liquidity needs to managed carefully, either through lower risk AAA assets or via closed-ended fund structures, though perhaps not as conservatively as we felt was required in 2024.

Given we expect modest interest rate cuts and stable if not stellar fundamentals, we expect 2025 to be another strong year for European ABS investors in a market where income will remain king.

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