



The Investment Case for Europe

September 2025

CONTENTS

AT THE POINT OF INFLECTION	3
LESS COMPETITIVE, MORE COMPLEX	4
CHANGING POLICY WINDS	5
STRUCTURAL FOOTHOLDS	9
NOT WITHOUT OBSTACLES	11
COMPLEXITY DEMANDS A PREMIUM	11
CONCLUSION	14
DISCLAIMER.....	15

AT THE POINT OF INFLECTION

In a rapidly shifting global economic environment, Europe finds itself at a crucial inflection point. Often dismissed for its sluggish growth, political fragmentation, and regulatory inconsistency, Europe now presents a unique case for strategic re-evaluation. Decades of structural inefficiencies, including fractured capital markets, high energy costs, and weak productivity, have weighed on investor sentiment. These challenges have shaped a narrative of stagnation and risk-aversion, dissuaded long-term capital deployment, and rightly reinforced the continent's position as a secondary player in the global investment hierarchy.

However, long-overdue proposals and initiatives aimed at combating these inefficiencies and driving capital to the continent suggest not only an acute focus on finding solutions but also a renewed sense of urgency and a more pragmatic approach. Policy momentum is building, exemplified by initiatives such as the EU's Readiness 2030 defense strategy, Mario Draghi's competitiveness agenda, and the continent-wide push to regain some global standing in artificial intelligence. We believe these developments signal a region in transition – one that is not merely reforming itself but actively courting capital to drive energy security, technological advancement, and market integration.

Change is happening. Quickly. Yet, we do not underestimate the formidable obstacles still ahead, which give rise to generic narratives around Europe's inability to reform at a sufficient pace. Examples include challenged capital deployment in the face of rigid, bank-led systems and the continent's thicket of differing legal jurisdictions, tax regimes, and fiscal agendas.

However, this misses the point. Opportunity arises when large and complex financing needs are met with capital scarcity in a less competitive, more complex market. Put simply, our thesis rests not on forecasting a probability of success for Europe but rather on our belief that Europe needs capital now and for years to come.

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The source for all market information, levels, performance, supply, demand, flows, defaults etc. is Bloomberg or Sona Asset Management internal estimates, unless stated.

LESS COMPETITIVE, MORE COMPLEX

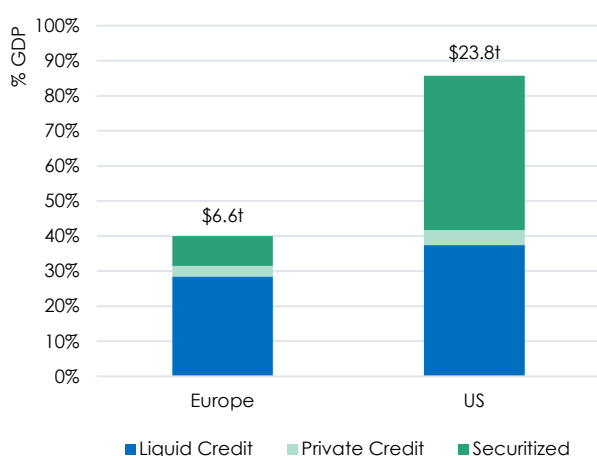
From an investing perspective, we see two unique, defining, and important features in Europe. The first is that Europe is less competitive. The second is that Europe is a complex region.

Europe is undergoing a period of transition at the heart of which are initiatives aimed at promoting growth. However, there are also many obstacles to overcome. We are not blessed with a crystal ball to tell us whether Europe's plans will prove successful. But in many ways, this misses the point. The opportunity isn't contingent on judging how successful these initiatives will be. Instead, it is predicated on our belief that Europe will need sustainable long-term capital to fund this growth.

Central to providing capital is our view that Europe is less competitive, no more clearly so than in comparison to the US. While there have been signs of progress, Europe is still largely a bank-led system. Capital markets – whether public liquid credit or private equity – are thinner and less crowded compared to those in the US, with a considerably smaller retail presence.

To illustrate this point, the US economy comprises a higher share of global GDP than that of Europe (25% vs 15%). However, the combined size of the liquid, private, and securitized credit markets in Europe is only 40% of GDP. For the US, that proportion is much higher, at 80%. US capital markets dwarf those of Europe.

European vs US capital markets



Source: Bloomberg, AFME, Preqin

¹ Source: Financial Times ("Can Europe finally fix its capital markets?"), May 2025

Even private credit, which has undergone exponential growth of late in Europe, partly at the expense of publicly syndicated markets, remains three times larger in the US than in Europe. Additionally, Europe has underinvested in growth sectors such as research & development and technology, owing to a lack of risk financing, particularly venture capital. This has contributed to Europe's lack of competitiveness and poor productivity performance.

There are initiatives aimed at improving the depth of capital markets in Europe and creating a more competitive environment for financing. Bank deleveraging since the GFC has resulted in a greater role for both capital markets and non-bank financing. Policymakers have also discussed a Capital Markets Union (CMU), which would undoubtedly be a positive step. However, this has also been debated for much of the last decade.

Nevertheless, as Mario Draghi's 2024 report highlighted, three main fault lines remain that hinder European capital markets: First, the lack of a single securities market regulator, compounded by the variation in supervisory practices and interpretations of regulations; second, a less unified post-trade environment for clearing and settlement; and third, fragmented tax and insolvency regimes.

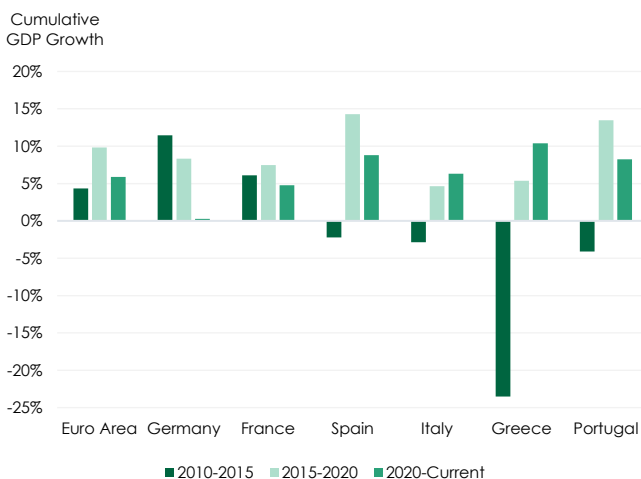
Indeed, insolvency regimes differ from jurisdiction to jurisdiction. According to the European Trade Union Confederation, around 200k companies go bankrupt every year in Europe, many of which are cross-border. However, insolvency law provisions differ, including, for example, the actual criteria for opening an insolvency proceeding, the ranking of creditors, and recoveries, among others. A recent European Parliament briefing stated that creditors of a bankrupt company in Greece can expect to recover 5%, while those in Luxembourg might enjoy closer to 75% recovery.¹

Similarly, tax regimes differ and can be highly complex, layered with bureaucratic processes. As a simple example, when an EU resident invests in securities in another member state, the payments received in return are subject to a withholding tax in the member state of residence, as well as in the member state of the investment. The only way to avoid double taxation is by submitting a refund claim for the excess tax withheld by the source country.

Fragmented tax and insolvency regimes are just the tip of the iceberg. The EU spans 27 countries; there are also three additional countries in the European Economic Area (EEA), as well as Switzerland and the UK, which sit outside of these blocs. While the EU was formed as a single market, the reality is that each country has its own distinct policy agendas. Regulatory inconsistencies create costly hurdles for firms operating across borders, stifling innovation and scale. Trade within the EU is still obstructed by barriers equivalent to high tariffs, particularly in services and digital markets, thereby diminishing the effectiveness of the single market. According to the IMF, regulatory barriers between EU countries act as a 45% tariff on goods and a 110% tariff on services.

Divergent national agendas and rising populism further complicate unified policymaking, potentially weakening investor confidence. A consequence of all this is the variation in growth rates across countries. For example, during the 2010–2015 period, Germany grew by more than 11%, but since 2020, it hasn't grown at all. Contrast that with Greece, which contracted by almost 25% in the early part of the last decade but has since 2020 grown by more than 10%.

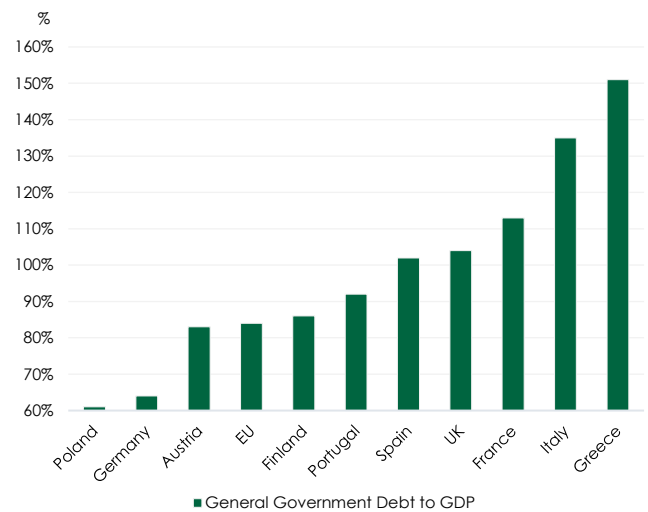
Growth in Europe is not uniform across countries



Source: Bloomberg

Similarly, fiscal policy can differ wildly due to the differing compositions of national governments. The level of government debt to GDP varies significantly from country to country. For France, Italy and Greece, the ratio eclipses 100% (and considerably so for the latter two), but for the more fiscally prudent Germany, for example, it is closer to 60%.

Fiscal positions show huge variance



Source: IMF

As we go on to discuss, there is scope for European capital markets to broaden and deepen, making them more competitive. Policy initiatives may also help create a more cohesive agenda and reduce fragmentation, thereby helping to allay some of the complexities.

However, Europe will ultimately remain defined by these characteristics to some degree. For some investors, this can appear off-putting, high-risk, and unattractive. We take the opposite view. We see the lack of competition and high complexity, especially when paired with a justified risk premium, as providing an attractive opportunity, especially for managers with local knowledge, presence, and resources.

CHANGING POLICY WINDS

As Europe enacts policies to grow its economies, so too do its financing needs grow. As highlighted above, the opportunity does not come from predicting how successful Europe will be. It comes from the simple truth that a system in need of capital will have to pay for it. Our role is not to predict a European revival but to provide capital where it's scarce, disciplined, and well-compensated.

Europe's historical discount, which is entirely justified, has been driven by real issues, including market fragmentation, regulatory complexity and rigidity, weak capital markets, and lackluster growth.

On one hand, Europe is slowly trying to become more competitive. Structural reforms, although uneven, are

in motion, and the need for market-based funding is rising as the limitations of a bank-centered model become clearer. Global sentiment is also shifting. America-first policies (tariffs, divisive tax proposals, and diplomatic friction) have cooled enthusiasm among international investors.

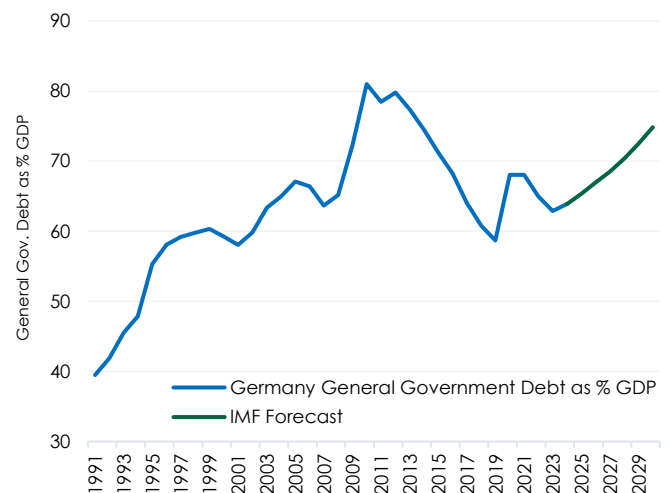
But, on the other hand, it takes time and capital to change course. Execution risk is inevitable, while the rigidities of past policy and years of under-investment mean there is no quick fix. For all the good intentions, a commitment to change and structural reform needs to be permanent. Europe needs growth, has shown its hand, and has started putting the wheels in motion; the opportunity rests in the need for long-term capital deployment.

LOOSENING THE FISCAL PURSE STRINGS

The EU's Readiness 2030 initiative, launched in early 2025, marks an unprecedented mobilization of defense investment in peacetime Europe. With roughly €800 billion planned over four years, the program introduces sweeping fiscal and financial measures to scale up military readiness and strategic infrastructure. These include relaxing the EU's fiscal rules to allow up to 1.5% of GDP in additional national defense spending, a €150 billion joint loan facility (SAFE), redirected EU funds for dual-use projects, expanded European Investment Bank support, and mechanisms to draw in private capital. The initiative is projected to add 0.8 percentage points to EU GDP over five years, with public investment multipliers potentially exceeding 2x.

Germany has emerged as a central driver of this effort. The government coalition has agreed to raise the defense budget by €500bn to the new NATO target of 3.5% by 2029, as well as borrow nearly €300bn for infrastructure over the same period. Put together, this amounts to nearly 20% of GDP in terms of fiscal stimulus, roughly as much as Germany spent on reunification in the first half of the 1990s.² At the most optimistic end, economists' forecasts suggest GDP growth could be as high as 2% in 2026, which would be enough to close the output gap and return Germany to an above-trend level of growth.

Europe is loosening the fiscal purse strings

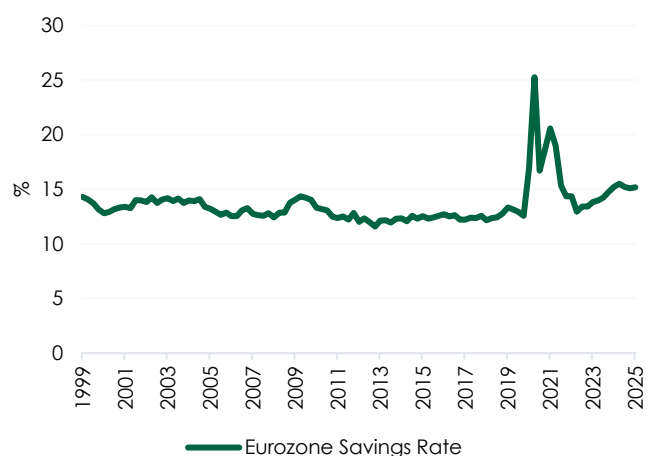


Source: IMF

CHANNELING SAVINGS TO THE REAL ECONOMY

Europe is a continent of savers. The current savings rate is 15%³, barely lower even as the ECB has cut rates 200bp since 2024. It has also not been lower than 11% over the last 25 years. By contrast, the savings rate in the US is less than 5%. Reports suggest that the total stock of retail savings in Europe is €31tn⁴ – a truly staggering number – and importantly, these savings have not resulted in longer-term wealth creation.

Europe has plenty of savings



Source: Eurostat

² Source: Deutsche Bank, July 2025

³ Source: Eurostat, March 2025

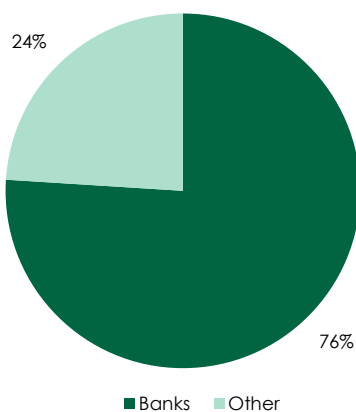
⁴ Source: Morgan Stanley, July 2025

Earlier this year, the European Commission published proposals around the launch of the Savings and Investment Union (SIU). High savings rates are a burden on activity, partly by lowering productivity. This initiative aims to bridge the gap between savings and investments into the real economy, thereby enabling companies to meet capital needs and increase returns for Europeans on their savings. The proposed reforms, if agreed, will take time to be implemented. Nevertheless, it is a step in the right direction.

A NEED FOR DEEPER FUNDING MARKETS

At the heart of the SIU is fostering the development of capital markets. Historically, Europe has always been a bank-centric funding market. That stands in contrast to the US, which has always had a heavier reliance on capital markets. Bank financing accounts for around 75% of all corporate funding in Europe, whereas in the US, this proportion is just 20%.⁵ Among other things, Europe's bank-centric model is a function of strict regulation, creating challenges for Small and Medium-sized Enterprises (SMEs), especially in accessing capital markets.

The corporate sector in Europe is reliant on banks for financing



Source: PitchBook LCD

However, ever-changing regulation, as well as sector consolidation, have seen banks retrench somewhat from lending in Europe since the GFC. This has enabled debt capital markets to play a more prominent role in providing capital. Credit markets have grown to fill the void left by banks. The total size of the liquid public credit market in Europe exceeds €4tn, an increase of 80% over the last ten years.

⁵ Source: PitchBook LCD, December 2024

But, as policy momentum builds to stimulate growth, so too does the need for further capital markets growth. The reality is, as illustrated earlier, Europe remains far behind the US in terms of depth and size of capital markets, especially relative to the size of their economies.

The securitization market is likely to be an important source of growth. Draghi's report touched on this, suggesting it could act as a substitute for the lack of capital market integration. It is also a key part of the SIU plan. Since the GFC, the market has shrunk considerably in Europe, and investor-placed securitizations make up only 2% of the European economy today versus 10% in the US (with half of that from CLOs).⁶

However, in June, the European Commission published a first look at proposals to simplify the EU securitization framework, as part of the broader SIU initiative. Proposals include tangible changes to operational hurdles to issuing and investing (due diligence, transparency requirements), as well as prudential requirements for banks. The outcome won't be known until next year; however, estimates suggest that by 2030, the investable European securitization market could as much as double in size to €1.2tn⁶ if the proposed changes are implemented. This works on the basis that banks could end up allocating 15% of their HQLA to securitization, and insurers allocate 5% of their investments.

Proposals could double the size of the securitization market in Europe



Source: Morgan Stanley

There is also the scope for growth from further issuance of Significant Risk Transfers (SRTs). Banks are

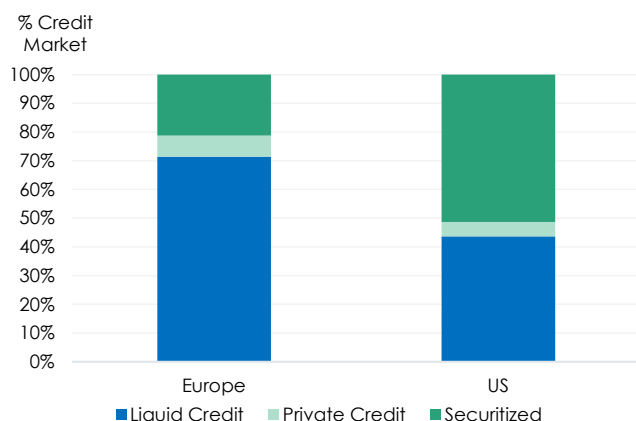
⁶ Source: Morgan Stanley, June 2025

likely to continue with their strategy of balance sheet optimization, with SRTs viewed as a preferable tool to do this versus raising equity. Demand has been healthy, while Basel 3.1/CRR 3 output floors also encourage SRT deals on new asset classes. For example, a recent report from Barclays suggests that if each bank in its coverage (42 in total) were to reach average SRT weight on total assets, it would imply a further \$219bn of growth in that market. At the maximum sector percentage, this increases to €1.3tn.

Recent draft regulation amending the Solvency II framework also has the potential to be helpful for the European securitization market. The most recent proposals include lowering capital charges for senior tranches of Simple, Transparent and Standardized (STS) securitizations. This would, in theory, better align them with corporate and covered bonds. There is also a proposal to significantly reduce capital charges for non-STS senior tranches. However, we should note that the proposals are less positive for mezzanine tranches, with the reduction being less meaningful.

Away from the securitized market, the role of direct lending (as the primary subset of private credit) continues to grow. The need for bespoke and tailored capital solutions will inevitably be shaped and helped by Europe's growth ambitions. Much like the securitized market, pressure from Basel III regulation should encourage a transfer of assets into the private sector. Including dry power, the private credit market is now €420bn in size. But together with the securitized market, these only constitute 30% of the entire credit market. As a point of comparison, in the US these markets comprise close to 60% of the market.

Private and securitized credit are less than one-third of European capital markets



Source: Bloomberg, AFME, Preqin

CLOSING THE AI GAP

Europe has recently launched a sweeping effort to catch up in the global AI race, led by major public and private investments, the creation of AI infrastructure, and strategic support for startups. Central to this push is the InvestAI program⁷, launched in February this year, which seeks to mobilize €200bn (€50 billion public funds and €150bn from private investors) to accelerate AI development across the continent. This is the EU's largest single bet on sovereign AI capacity – designed not only to catch up with the US and China, but also to institutionalize an open-science alternative where compute, data, and funding are shared across the continent.

Member states are also stepping up individually, with Germany's SAP, Deutsche Telekom, and Ionos working on a major data center, while other tech ecosystems across Europe seek to expand compute capacity and innovation capabilities.

French President Emmanuel Macron has emerged as a leading political champion of AI in Europe, unveiling a bold €109bn national investment plan focused on creating new compute clusters and establishing France as a central hub in the continent's AI ambitions. A key factor in France's advantage is its robust nuclear energy infrastructure, which provides a stable and low-carbon power source – an essential asset for energy-intensive AI data centers. Macron's strategy leverages this energy security to attract both public and private investments in AI, while also positioning France as a sustainable leader in tech development. By combining large-scale funding, infrastructure development, and startup-friendly reforms, Europe is signaling a serious bid to close the AI gap with the US and China. Whether that bid is successful or not remains to be seen, but the efforts create opportunity.

A CHEAPER, SUSTAINABLE ENERGY SOURCE

It's no secret that Europe pays a high price for energy. As the biggest global gas and LNG importer, historically, Europe pays up to three times more than the US does. In recent years, it has been as much as five times. The surge in energy prices due to the conflict in Ukraine cost European governments €650bn between September 2021 and January 2023⁸. And as the energy crisis showed, it is not only the high level of energy prices which impacts Europe's

⁷ Source: European Commission, February 2025

⁸ Source: UK Energy Research Centre, January 2025

competitiveness, but also price volatility and unpredictability.

In 2022, Europe imported 27% of all its oil, 45% of gas, and 50% of coal from Russia. A move away from dependency on Russian energy is imperative for financial stability. And the transition is in motion. In 2022, the European Commission introduced its “REPowerEU” plan to phase out Russian fossil fuel imports with the primary objectives of saving energy, diversifying energy supplies, and producing clean energy. By the end of 2027, the EU plans to cease imports of Russian pipeline gas, LNG, and oil.

The initiative to move away from high-cost Russian energy is a crucial stepping stone to restoring stability in Europe’s crippled industrial sectors. In the chemicals sector, for example, current gas prices are ~3.5x higher in Europe than in the US⁹, given the latter’s access to cheap shale gas. Cheaper input costs, therefore, have the potential for Europe to regain some competitive edge.

STRUCTURAL FOOTHOLDS

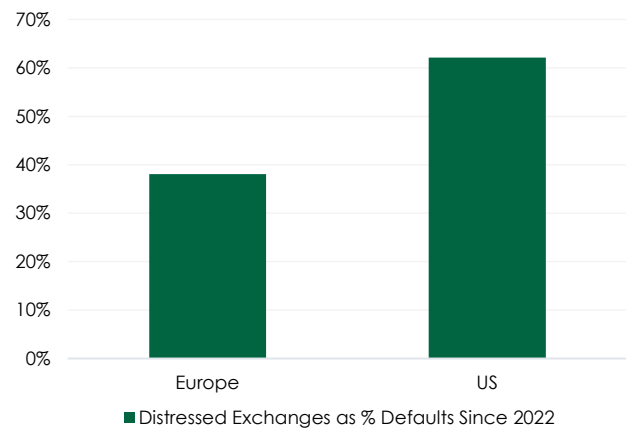
Beyond the policies discussed, there are also structural features inherent in Europe that should be taken into consideration.

COMPLEXITIES IN BANKRUPTCIES BUT FEWER LMEs

As noted earlier, relative to the US, where the bankruptcy regime and system are centralized, structured, and well-trodden, the equivalent in Europe is far more complex and fragmented, differing from jurisdiction to jurisdiction.

This complexity, in our view, is also a reason why liability management is less common. Of all defaults in the high yield market in the period of 2022 to 2024, 38% were distressed exchanges in Europe. However, for the US, that proportion was 62%.¹⁰

Distressed exchanges are less common in Europe



Source: Goldman Sachs

This shouldn’t understate the fact that liability management exercises (LMEs) have become increasingly popular in recent years. More than a decade of loose covenant protection, low funding costs, and a competitive financing market is mostly to blame, providing leverage for companies and sponsors to negotiate with creditors. In the US especially, drop-down/unsub financings and up-tiering transactions have been especially popular.

While Europe has not been entirely immune from this sort of behavior, it is overall less commonplace. This is partly a reflection of the differing fiduciary duties of directors, intercreditor agreements, and restructuring processes. But more simply, Europe has fewer creditors, which helps to align interests and encourage collaboration between creditors and sponsors. There is also perhaps a cultural argument, with creditor-on-creditor violence seen very much as a last-resort tactic in Europe.

This isn’t to say that Europe is devoid of unfavorable regimes. Numerous high-profile situations in the last few years have flagged the rising influence of creditor-on-creditor violence and LMEs. In our view, Europe’s complexity and lower competition make for fewer LMEs relative to the US.

FUNDAMENTAL STABILITY

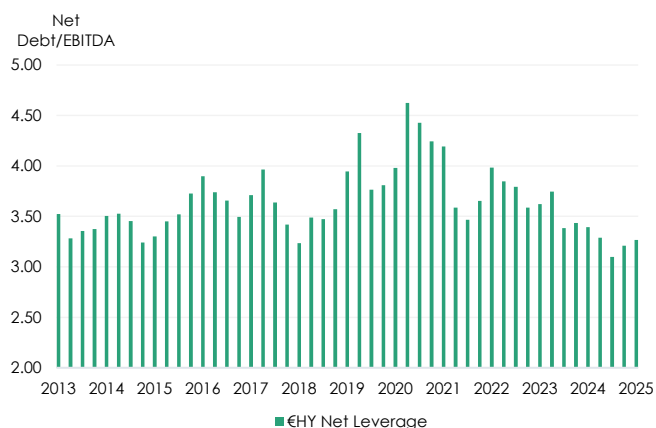
Notwithstanding the natural cyclicity of corporates, fundamentals today in Europe, especially in the high yield market, are comparable to where they were ten years ago. Net leverage, for example, is currently 3.3x,

⁹ Source: Barclays, July 2025

¹⁰ Source: Goldman Sachs, July 2025

on a downward trend for much of the last few years, and consistent with where it was ten years ago. It is also below the long-term median level of 3.6x, as well as the equivalent in the US.

European HY net leverage is flat over the last ten years



Source: Goldman Sachs

Given higher interest costs, there has been greater pressure on interest coverage metrics, but even then, EBITDA/cash interest at 2.1x is slightly higher than it was ten years ago.

At the same time, the average credit quality of the high yield market has been stable for much of the post-GFC period. BBs constitute 65% of the market, exactly in line with the average for the last 15 years, while CCCs constitute less than 10%. Similarly, in the broadly syndicated loan (BSL) market, while the average rating is one notch lower than high yield at single-B, this has also been entirely consistent since the GFC.

Europe is embarking on a potential new credit cycle defined by massive fiscal loosening. It remains to be seen if this will ultimately be successful. Still, given the need for capital, it is helpful that the starting point for corporate fundamentals is reasonable in aggregate. This should, however, be balanced with the fact that there is dispersion at the sector level. Cyclical sectors, such as chemicals, provide good examples, where leverage is elevated on the back of the weaker, bottom-of-the-cycle earnings.

MANY NATIONAL CHAMPIONS

Another defining structural feature of Europe is its many national champions within each sector, consistent both in the investment grade and high yield market.

This is particularly the case in so-deemed "strategic" sectors. For example, in the energy sector, there are companies such as EDF (France), RWE (Germany), Orsted (Denmark), EDP (Portugal), and Equinor (Norway). In autos, there are VW (Germany), Stellantis (France/Italy), and Renault (France). In telecoms, there are Telefonica (Spain), Vodafone (UK), Orange (France) and DT (Germany).

While national champions are not immune from potential stress, in aggregate, they tend to have a strong competitive advantage and solid underlying fundamentals, at times offering attractive trading opportunities, especially in volatile markets. This also extends to potential government support/initiatives for such companies out of strategic interest (usually as a result of their status as large employers).

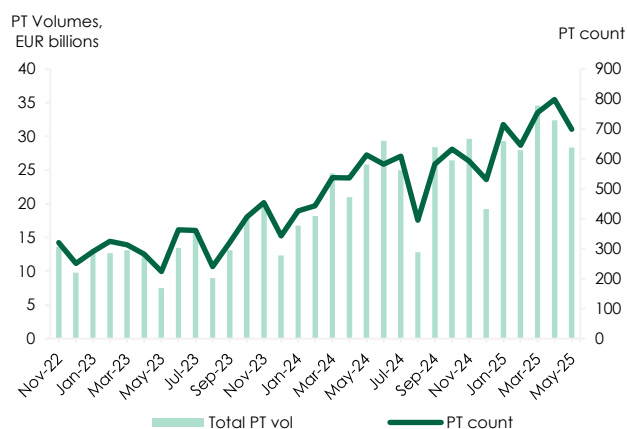
LIQUIDITY IS NOT THE HEADWIND IT USED TO BE

A long-held assumption in Europe is that trading liquidity, especially below investment grade, is poor. While there have undoubtedly been times in past cycles when this has been evident, liquidity conditions have improved significantly.

A big reason for that is the growth of portfolio trading (PT). In the first half of 2025, PTs happened every 15 minutes in Europe¹¹ due to improvements in technology and automation, as well as increased appetite and positive use cases. In aggregate, PTs account for 14% of market share in the IG market in Europe and 10% of the HY market. The share of bonds in the HY market that do not trade in a given month is now just 1%, the lowest it has ever been.

¹¹ Source: Barclays, July 2025

Portfolio trading is driving better liquidity



Source: Barclays

There is also scope for liquidity to improve further, thanks to the self-reinforcing benefits of PTs. Portfolio trading has reduced the share of bonds that don't trade, and, as a result, customized PTs will allow for more precise and dynamic portfolio construction. As more bonds trade regularly over time, this can allow for more dynamic and precise portfolio construction, including more customized PTs, driving further growth. Additionally, further technological advancements will increase the efficiency of execution, thereby improving liquidity through increased trading.

NOT WITHOUT OBSTACLES

Europe has ambitious plans. There are policies that, if successful, could transform the region for years to come, courting capital to the continent.

While we primarily see the opportunity in the need for capital, rather than judging how successful Europe will be, we must also acknowledge that there are many potential obstacles along the way.

Some of these are more obvious. Europe is culturally a region of savers. Investment has been directed at legacy industries, like autos, as opposed to growth areas. Europe is also challenged by demographics, specifically an ageing population.

In addition, while there is excitement about the prospect of fiscal loosening, there are also considerable fiscal constraints. France, for example, is likely to have a budget deficit in excess of 5% of GDP until 2027.¹² France needs 0.5–0.6% of GDP in yearly

fiscal tightening to offset rising debt service and defense spending costs and prevent the deficit from increasing further. Some of these constraints are already being felt, particularly by those exposed to government-set pricing policies.

Some of the obstacles are also less obvious. For example, in Germany the civil engineering sector is suffering from a structural labor shortage at a time when it needs to build substantial infrastructure. Meanwhile, Europe is trying to close the AI gap to the US and China, but is it too little too late? European capital markets need to grow, but is there any way around the bureaucratic and never-ending complications of different insolvency and tax regimes?

We don't have the answers to these questions. Only time will tell, but what matters is that Europe has a bold plan of policy initiatives and, with that, a need to partner with managers who can provide capital.

COMPLEXITY DEMANDS A PREMIUM

The inherent complexities of Europe and its historical rank as a secondary player globally have meant that European assets trade at a premium to those in the US across almost every facet of liquid, private, and structured credit. This is justified. However, at a time when change is happening and Europe needs capital, this premium looks increasingly attractive.

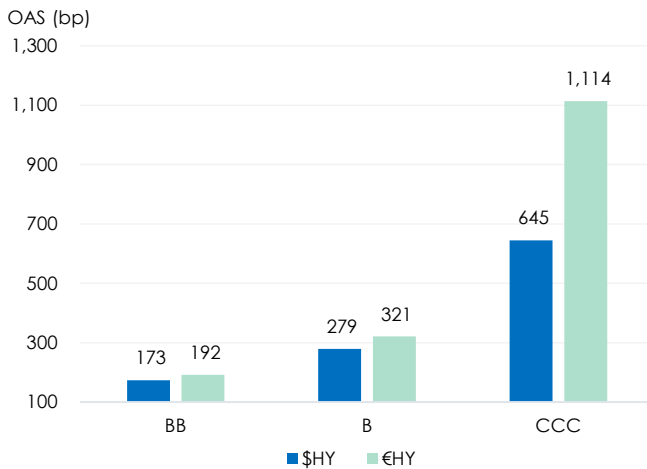
PUBLIC CREDIT

There is no doubt that European public credit markets remain inferior in terms of size relative to those in the US. The IG market is roughly half the size in Europe, the HY market is one-third of the size, and the BSL market one-quarter of the size.

But to partly compensate for this, European markets also trade more widely. Over the last twelve months, average IG spreads in Europe have traded 15bp wider than in the US, HY spreads 30bp wider, and BSL spreads slightly more than 50bp wider.

¹² Source: Deutsche Bank, June 2025

Spreads are wider in Europe versus the US



Source: Bloomberg, PitchBook LCD

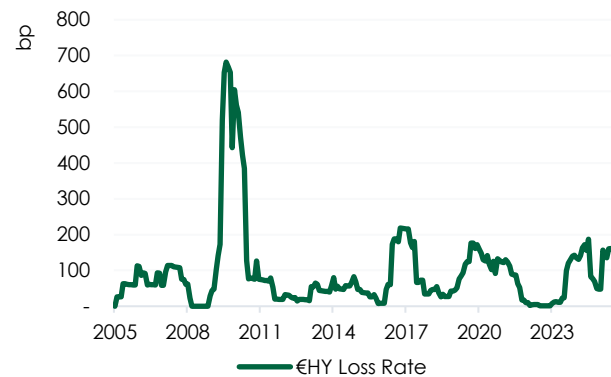
While there are points in time where this relationship doesn't hold – the pandemic being a good example of when US spreads peaked at a higher level – over the long term, the premium in Europe is still consistent. A more accurate way of showing this is to adjust for the differences in credit quality between the two markets.

Using the HY market as an example, the average credit quality in Europe has always been higher than in the US. For example, since the start of 2010, BBs have averaged 67% of the European market but only 45% in the US. Similarly, the CCC (and below) market in Europe has only averaged 8% whereas in the US that number is closer to 15% and at the peak, 25%.

To take this one step further, rebasing spreads to reflect the difference in credit quality between the two HY markets, Europe has, on average, offered a ~45bp incremental spread pickup since 2010.

Importantly, the incremental spread on offer contrasts with the historical trend in defaults, which has been lower in Europe. Since 2005, the median rolling twelve-month default rate in Europe has been just 1.1%, whereas for the US it is 1.8%. And for Europe, loss rates have been somewhat trivial. The through-the-cycle average is only ~80bp (over twelve months) and has only ever moved above 200bp in the GFC.¹³

Historically, default losses have been manageable in Europe



Source: Barclays

Assuming losses don't explain the European premium historically, an alternative hypothesis is liquidity. However, as flagged above, we think this argument is weakening given the rise of PTs, allowing for crowdsourcing of liquidity. As a result, we have seen a structural decline in, for example, the tail of bonds that do not trade. At the same time, the rise of fixed-maturity funds has encouraged significant inflows into European credit, creating a powerful demand base even during times of stress.

That leaves volatility. But even this can be disputed. For example, the trailing one-year volatility of daily returns in the high yield market has been almost consistently lower in Europe versus than in the US for much of the last ten years. This is especially the case during periods of stress.

Volatility is lower in Europe



Source: Bloomberg

¹³ Source: Barclays, September 2024

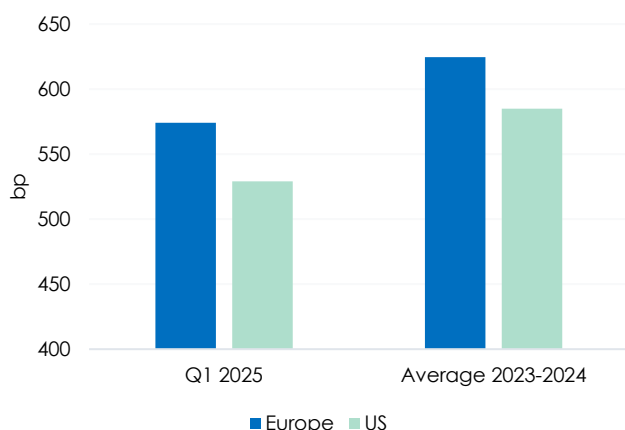
Neither default losses nor volatility appear to explain Europe's premium, while the liquidity argument is waning in our view. Thus, this leaves Europe's inherent complexity as likely being the primary driver and a justifiable one at that. Nevertheless, for those investors who are willing and able to navigate this complexity, at a time when Europe is trying to enact change, there are opportunities to capitalize.

PRIVATE CREDIT

The similarities extend to the private credit market. European private credit, which as a broad cohort includes direct lending, mezz, special situations, and distressed, amongst other strategies, is significantly (3x) smaller than that in the US, despite what has been almost exponential growth in recent years (the market more than doubled in size from 2018 to 2024).

And Europe's premium is evident. More recently, the incremental margin found in European unitranche, for example, versus the equivalent in the US is ~45bp, while the average for all deals through 2023 and 2024 was ~40bp. It is also common to find a larger original issue discount (OID) in Europe.

Direct lending deals trade at a premium in Europe compared to the US



Source: Kroll Bond Rating Agency

STRUCTURED CREDIT

While it is fair to state that the securitized market in the US far eclipses that in Europe in terms of size (\$12.2tn versus \$1.4tn), it should be noted that this is somewhat reflective of differences in the structure of the

mortgage markets in each geography. Agency mortgages compose a huge part of the overall securitization market in the US, whereas in Europe, this is replaced by the covered bond market.

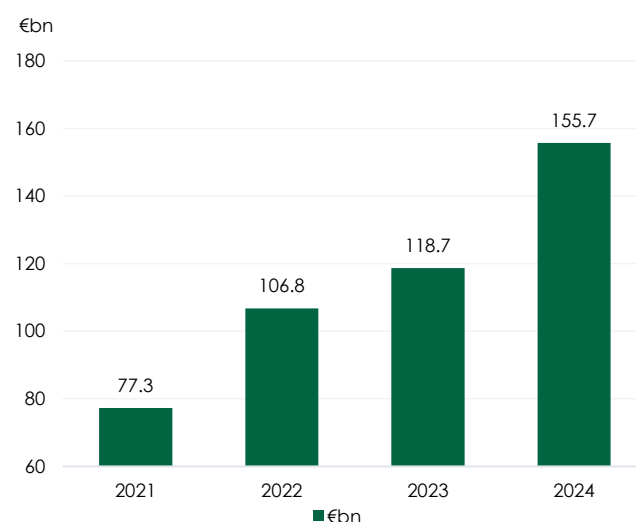
Where Europe appears to have a competitive advantage is in Significant Risk Transfers (SRTs). An original European financial innovation, these remain dominated by European banks (which account for over 80% of global issuance).¹⁴ US institutions are only beginning to explore this market, whereas European banks have been strategic and regular issuers of SRTs.

As a result, most data on pricing comes from Europe – and those yields have been attractive, often in the low-to-mid double digits in percentage terms, unhedged. European mezzanine/junior tranche yields usually range in the 8% to 10% context depending on tranche thickness and portfolio quality.¹⁵

Because the US SRT market is nascent, a direct Europe-vs-US pricing comparison is challenging. However, early indications are that US banks, when they do SRT trades, have paid yields similar to or slightly below European levels, mainly because US deals so far have been either high-quality portfolios or “club” placements.

Another interesting dynamic relates to US investors' search for yield in Europe's SRT market, resulting in tighter pricing. In other words, when it comes to SRTs, the relative value advantage remains on the European side.

SRT issuance in Europe has doubled in three years



Source: AFME

¹⁴ Source: ESRB

¹⁵ Per Sona's internal analysis of deals reviewed.

Meanwhile, the CLO market continues to go from strength to strength in Europe. Year-to-date, new issue volumes have already surpassed €30bn and are 24% ahead of the comparable period last year. Deutsche Bank forecasts full-year supply of €50bn, roughly matching the record from 2024.

While spreads are currently ~15bp wider in European AAA CLOs versus those in the US, spreads have historically been comparable, but generally look more attractive in Europe as quality declines. Equity tranches, for example, are tracking an annual rate of 15–20%.¹⁶ In addition, secondary AAA spreads of 120bp look particularly attractive in the context of where non-financial corporate bonds trade in Europe, at just 75bp.

In general, yields on offer in the European securitized market are compelling, especially risk-adjusted. AAA-rated prime RMBS, CMBS, CLOs, and UK non-prime RMS offer up to 5% yields currently. That increases to 7% for UK non-prime BB-rated CMBS and 10–15% for CLO single-B and equity tranches.

CONCLUSION

Momentum in Europe is shifting. Years of stagnation are giving way to real actions aimed at promoting growth. Reforms are being targeted at driving greater integration of capital markets. Initiatives are in place to tackle structural inefficiencies.

Europe is a credible and competitive offering from an investing perspective, especially when considering the historical discounts across public, private, and structured credit markets.

There are inevitable question marks around the execution of the various proposals, policies, and initiatives, given Europe's track record. Europe is a large region; its financing needs are complex, while its financial capabilities are less competitive versus other regions.

However, in many ways this misses the point. Europe is already an attractive proposition because of its unique complexity. These proposed policies aimed at driving long-term growth will mean a substantial need for capital. The opportunity arises less from judging Europe on its success, but more so in the need for sustainable, long-term capital to fund growth.

Subsequently, we believe the relative success of managers comes down to not just spotting opportunities as they arise, but from having a long-established presence in European credit markets. Integral to this are understanding factors such as tax, legal, and regulatory frameworks that differ by jurisdiction. This requires a deep and well-established team with local knowledge, relationships, and appropriate breadth of coverage, to navigate opportunities as they arise.

¹⁶ Source, Morgan Stanley, May 2025

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