

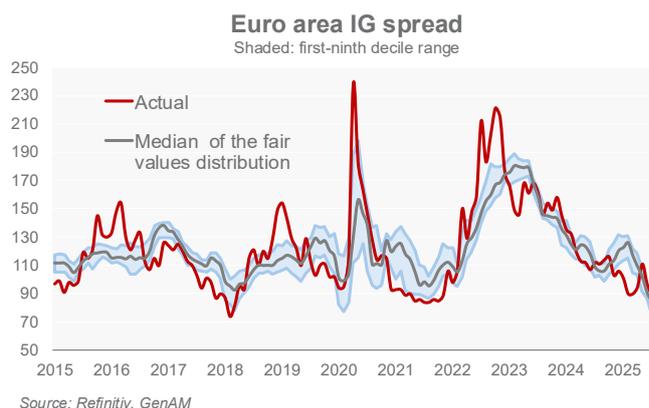
Core Matters

What drives Euro area credit Spreads?

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Our Core Matters series provides thematic research on macro, investment, and insurance topics

- Euro area corporate spreads are at historical lows. To assess to what extent this is consistent with fundamentals, and more broadly what is causing this compression, we develop a factor based econometric framework to estimate a fair value model for IG and HY Option Adjusted Spreads (OAS).
- According to our model, the current low level of spreads is consistent with the business cycle, credit fundamentals, and the elevated level of global liquidity. The sharp compression of the spread has been driven to a large extent by corporate deleveraging.
- This development is consistent with our long-held view that credit markets would exhibit a structural compression in risk premia, driven by a sustained convergence in perceived credit risk between developed market sovereigns and the corporate sector.
- Our positive macroeconomic outlook for the euro area economy in the coming months, combined with the anticipated positive impact of previous ECB rate cuts on bank lending, should help maintain these spreads at low levels.





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1. Introduction and Motivation

The fall in Euro area Option Adjusted Spreads (OAS) to levels not seen since 2007 has raised the question of their consistency with fundamentals, especially given the still looming uncertainty around the strength and speed of the economic recovery. We try to provide an answer by means of an econometric model. Our main goal is to provide a model that measures the importance of different fundamental drivers and, helps estimate what the “fair value” of these spreads should be.

The core measure we use is default risk, which is the chance a borrower will not pay back their debt, multiplied by the loss if that happens. Default happens when a company’s value falls below the amount it owes. We then consider several factors:

- Stronger economic activity tends to increase a company's value, reducing credit risk.
- Greater uncertainty raises the risk of negative outcomes for companies.
- Higher debt (leverage) makes default more likely.
- Tougher borrowing conditions mean companies have more difficulty refunding their debts.

We also consider factors affecting the broader market for fixed income (bond) securities:

- The composition of Central banks’ holdings affects the relative prices of credit versus government bonds: Sovereign bond purchases increase the spread by lowering the risk-free yield, while corporate bond purchases compress the spread.
- Abundant global liquidity lowers risk aversion and boosts demand for credit compared to similarly rated government bonds.

The approach is similar to the one introduced by the International Monetary Fund (IMF) to estimate fair values for several asset classes as a benchmark for its financial stability assessment contained in the bi-annual [Global Financial Stability Report](#). We expand the set of variables beyond the business cycle and uncertainty measures considered by the IMF.

A factor-based model to assess whether the current low OAS level is “fair”

2. The Model

Based on established research, we use a factor model to capture all the main elements of credit risk. We focus only on flow variables (such as economic activity and uncertainty) and do not include asset prices or returns, to avoid circular reasoning. For business cycle conditions and uncertainty, we explore several possible measures (see the table below), to take into consideration all the possible dimensions. Our business cycle measures are mostly forward-looking, such as GDP forecasts and business sentiment surveys. Our risk and uncertainty measures also come from surveys, focusing on differences in responses and downside risks.

The model accounts for the business cycle as well as the broad credit, fiscal, and liquidity conditions...

To estimate the leverage, we use the ratio of total euro area nonfinancial business debt-to-GDP. To reflect the role of bank lending, we use data from the ECB's Bank Lending Survey on lending standards for large firms. To capture supply and demand imbalances in the bond market, we include:

- The size of ECB holdings of government and nonfinancial private sector bonds as share of eligible securities
- The BIS global liquidity indicator (year-on-year growth in cross-border lending)

We then estimate the following specification on monthly data, over the 2012-2025 period:

$$\begin{aligned} Spread_t = & \alpha_0 - \beta_1 Business\ cycle\ indicator_t + \beta_2 Uncertainty\ indicator_t \\ & + \beta_3 Lending\ Standards_t + \beta_4 Private\ Debt\ to\ GDP_t \\ & + \beta_5 QE_{GovBonds}_t - \beta_6 QE_{GoCredit}_t - \beta_7 GlobalLiquidity_t + \varepsilon_t \end{aligned}$$

We run this specification for IG (overall and split into Financials and Nonfinancial) and HY spreads using every combination of business cycle and uncertainty proxies. The fit of the models is good (above 60%); all the coefficients have the expected sign and are significant at least the 10% level. The resulting equations give us a range of fair value estimates for credit spreads. To assess the actual fair value of the spread, we use the median value from this range as our benchmark. This method is quick and recognises that no single measure can perfectly capture each economic factor, so it reflects the uncertainty in estimating fair values.

2.1 Data and proxies for business cycle and uncertainty

...and does not signal any major mispricing

We collect data for 11 different business cycle measures and 8 different uncertainty measures, leading to 88 different models (and fair value estimates) for each type of spread.

We use some unique ways to measure uncertainty. For example, the ZEW index asks investors if they expect unemployment to go up, down, or stay the same in the next year. From their answers, we calculate two measures—the [Herfindahl-Hirschman Index](#) and the [Theil entropy index](#), which are highest when opinions are split and lowest when most people agree. We also use analyst forecasts for company earnings to estimate the probability of negative earnings growth over different time frames.

Proxies for business cycle and uncertainty

Business cycle	Uncertainty
One year ahead GDP growth (ECB SPF)	EPS growth dispersion (12mth ahead)
Manufacturing PMI	EPS growth dispersion (18mth ahead)
Services PMI	EPS growth dispersion (Long term)
Composite PMI	ZEW – Herfindahl index
Ind. Prod. (% chg. Year-on year)	ZEW – Theil index
EPS growth (12mth ahead)	Prob of neg. EPS (12 mth ahead)
EPS growth (18mth ahead)	Prob of neg. EPS (18 mth ahead)
EPS growth (Long term)	Prob of neg. EPS (Long Term)
Economic Sentiment Index	
E-coin coincident index	
ZEW confidence index	

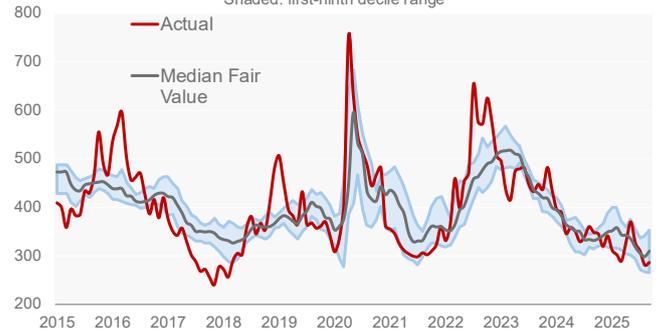
Currently, credit spreads are at historically low levels but still broadly match economic fundamentals. Spreads for both financial and non-financial IG borrowers appear in line with fundamentals, while the HY spread is a little lower, if still well within the 10th to 90th percentile range.

Euro area IG spread
Shaded: first-ninth decile range



Source: Refinitiv, GenAM

Euro area HY spread
Shaded: first-ninth decile range



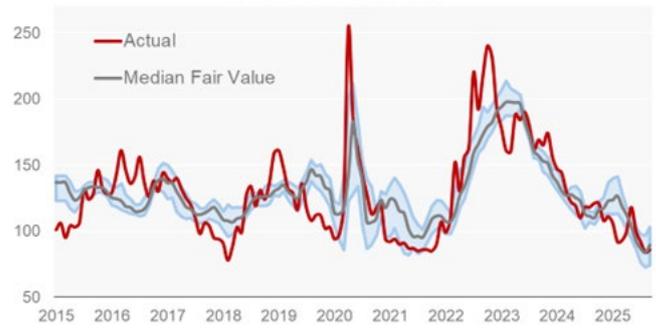
Source: Refinitiv, GenAM

Euro area Nonfin. IG spread
Shaded: first-ninth decile range



Source: Refinitiv, GenAM

Euro area financials IG spread
Shaded: first-ninth decile range



Source: Refinitiv, GenAM

2.2 Weighting the drivers of spreads evolution.

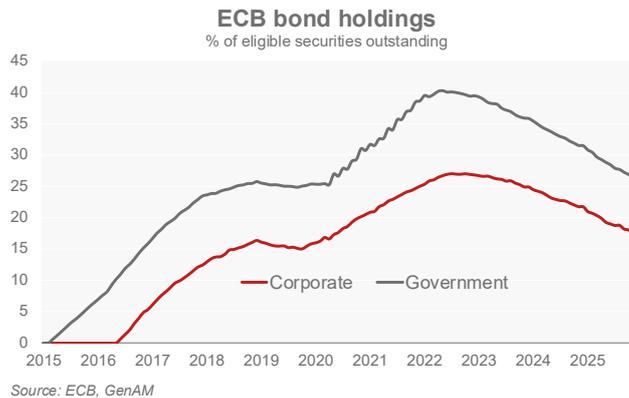
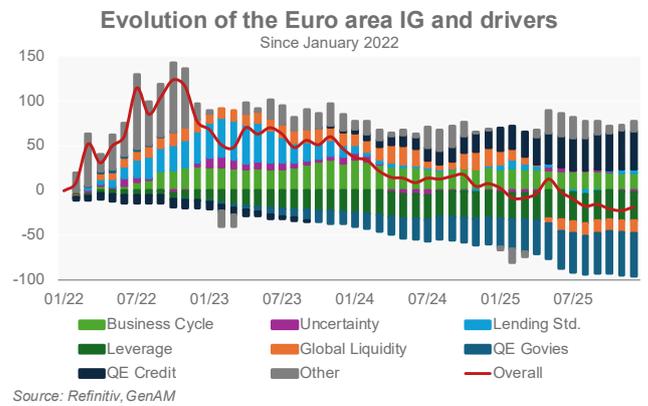
The regression framework allows us to measure which factors have the biggest impact on credit spreads. To do this we run the model with all variables converted in z-

Deleveraging crucial for the spread compression

score, so that the size of the betas can be compared within and across equation. By the same token we use the first principal component for the business cycle and uncertainty indicators, expressed as z-scores as well. The results show the business cycle and uncertainty have less influence than to leverage and financial conditions. ECB bond purchases have large betas, with the expected opposite signs, but, given the similar and contemporaneous evolution, the net effect is smaller and points to a mild contribution to spread compression.

We can also use the estimated coefficients to break down how much each factor has influenced spreads over time. For example, the chart below shows that the initial jump in IG spreads in 2022 was due to extraordinary (non-fundamental) events like Ukraine invasion. After that, tighter bank lending standards kept spreads elevated. Over time, the drop in private sector leverage has become the main driver for the narrowing of spreads since late 2023, according to our model.

Regressions using standardised covariates				
Sample Jan 2015 - Oct. 2025. OLS with heteroscedasticity adjusted Standard Errors				
Spread	IG	Fin. IG	Non Fin. IG	HY
Constant	118.66	125.60	114.37	402.77
	(2.958)**	(2.862)**	(3.163)**	(10.225)**
Business Cycle	-12.81	-14.54	-11.75	-34.54
	(3.140)**	(3.456)**	(3.083)**	(8.769)**
Uncertainty	9.26	7.92	10.00	40.04
	(3.140)**	(3.106)**	(3.243)**	(11.110)**
Lending Std.	12.73	16.73	10.27	30.06
	(3.986)**	(4.181)**	(3.960)**	(12.001)**
Corp Debt to GDP	11.30	10.63	11.72	44.54
	(2.953)**	(3.162)**	(2.882)**	(9.249)**
QE Govies	50.13	68.75	39.90	50.86
	(16.318)**	(15.457)**	(17.927)**	(-23.278)**
QE Credit	-54.97	-74.02	-44.21	-108.28
	(15.612)**	(14.589)**	(17.235)**	(-52.917)**
Global Liquidity	-13.47	-16.06	-11.87	-23.24
	(3.050)**	(3.179)**	(3.024)**	(9.329)**
R-squared:	0.59	0.62	0.56	0.53
F-statistic:	25.18	28.36	22.27	19.38
Coefficients significant at the * 5% and ** 1% level				



3. What it means for our credit outlook

Credit spreads are currently trading close to cycle tight, reaching levels last observed in the aftermath of the Global Financial Crisis. This development is consistent with our long-held view that credit markets would exhibit a structural compression in risk premia, driven by a sustained convergence in perceived credit risk between developed market sovereigns and the corporate sector.

Credit benefit from a structural compression in risk premia

On the sovereign side, the post pandemic fiscal environment has been marked by a persistent deterioration in public sector balance sheets, with elevated debt to GDP ratios and structurally weaker primary fiscal positions. The gradual erosion of fiscal space has prompted a reassessment of sovereign risk, effectively narrowing the relative value differential between government bonds and corporate credit.

By contrast, the corporate sector has entered the current phase of the cycle with exceptionally robust fundamentals. Many issuers undertook proactive balance sheet repair following the pandemic, including opportunistic refinancing during the low-rate period, conservative shareholder distributions, and disciplined capital expenditure. As a result, corporate borrowers — particularly in the investment grade universe — exhibit strong free cash flow generation, improved leverage metrics, and comfortable interest coverage ratios. Indeed, our modelling shows deleveraging as the main force behind spread compression.

These dynamics continue to underpin benign default expectations across most sectors. The more recent pivot by major developed market central banks towards easier monetary policy has further reinforced the tightening trend in spreads. As policy rates decline, investors have increasingly sought assets offering enhanced carry, positive roll down, and a more attractive yield per unit of duration relative to sovereign benchmarks. The reset lower in money market yields has triggered meaningful outflows from cash instruments, with investors reallocating into longer duration corporate credit to mitigate reinvestment rate risk and lock in yields ahead of further rate cuts.

Lower money market yields trigger inflows

This has been clearly reflected in market flows, most notably through the rapid expansion of fixed maturity credit funds, which offer investors carry visibility, predictable return profiles, and reduced mark-to-market volatility as the fund approaches maturity. These vehicles have become key channels for channelling excess liquidity into corporate bond markets and have significantly contributed to the strength of technical factors, as shown by the additional contribution from global liquidity to spread compression in our model.

Euro and US credit markets levels (since 2007 in OAS vs gvt,)

	IG Non-fin	IG Non-fin AA	IG Non-fin A	IG Non-fin BBB	IG Fin,	IG Fin, AA	IG Fin, A	IG Fin, BBB	HY	HY BB	HY B	HY CCC	US IG	US IG Non-Fin,	US IG Fin,	US HY
Min	47	25	43	58	41	31	56	89	178	116	200	322	74	74	73	241
Max	373	188	324	530	468	316	652	1875	2291	1551	2598	6571	154	622	589	2147
Mean	129	76	103	162	155	101	158	278	504	372	620	1266	99	157	152	516
Current OAS	75	48	65	84	78	53	72	94	256	158	344	1283	78	79	77	274
Stdev	52	27	43	77	75	55	105	225	311	220	331	748	21	87	73	267
Z score	-1.03	-1.03	-0.89	-1.02	-1.03	-0.86	-0.82	-0.82	-0.80	-0.97	-0.83	0.02	-1.03	-0.90	-1.02	-0.91
Percentile	0.04	0.07	0.05	0.03	0.04	0.11	0.04	0.01	0.04	0.03	0.06	0.60	0.08	0.01	0.01	0.03
(Current-Low) / (Max-Low)	0.09	0.14	0.08	0.06	0.09	0.08	0.03	0.00	0.04	0.03	0.06	0.15	0.05	0.01	0.01	0.02

Source: Bloomberg, BofAML Indices, GenAM

Our model-based analysis corroborates this narrative. The current tightness in credit spreads is primarily driven by two dominant forces:

Strong Micro Fundamentals

- Improved leverage and debt service metrics
- Low expected default rates across the credit spectrum
- Robust profitability and cash flow generation
- Manageable refinancing walls due to prior liability management

Ample System Liquidity

- Abundant cash searching for yield enhancement.
- Compressed risk aversion and liquidity premia
- Structural inflows into credit dedicated vehicles
- Supportive secondary market conditions and improved liquidity depth

Together, these drivers anchored spreads at structurally tight levels, reflecting a combination of cyclical support from the monetary easing cycle and structural strength within the corporate credit universe, as well as a repricing of sovereign credit risk, and we believe that the situation will persist over the coming quarters, hence our still preference for credit over government sovereign bonds both in the US and Europe.

4. Conclusion

We present a quantitative, factor-based framework for assessing the relative importance of corporate fundamentals, cyclical and market conditions in explaining Euro area corporate bond spreads.

The results of our model support the view that the currently narrow spreads are primarily underpinned by robust corporate fundamentals, particularly low leverage. Our positive outlook for the euro area economy, combined with the anticipated supportive impact of previous ECB rate cuts on bank lending, should help sustain these spread levels.

 **IMPRINT**

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