HSBC Asset Management

Europe Insights

Rebuilding confidence

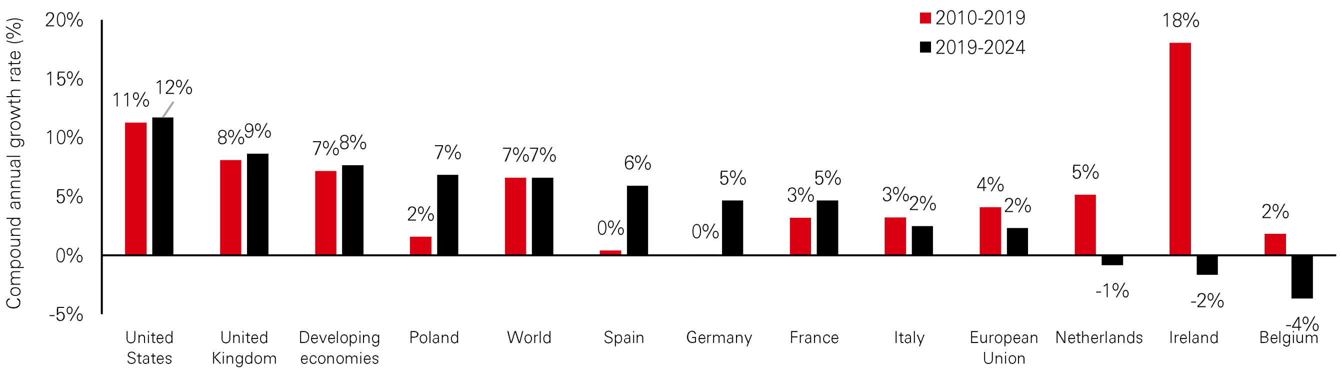
October 2025

For professional clients only

Market spotlight: Europe's supply chain diversification

The European Union remains one of the world's most important hubs for trade and investment. Over the past decade, European firms have steadily expanded abroad, with the US now leading destination for foreign direct investment (FDI) originating from EU-based companies. While FDI flows often reflect near-term drivers such as growth prospects, policy incentives, or cost considerations, they also serve as a forward-looking signal of firms' strategic priorities and long-term positioning.

Figure 1: FDI instock dynamics over 2019-2024 compared to 2010-2019



Source: United Nations Trade and Development, HSBC AM calculations - as of 17/09/2025

The Covid-19 pandemic and the subsequent energy crisis marked a turning point. Since then, FDI inflows into the EU have halved, even as the US and several developing economies have continued to attract steady commitments. Looking beyond annual volatility, structural patterns emerge as disinvestment has been concentrated in the Netherlands, Ireland, and Belgium, where multinational headquarters and holding companies dominate the landscape. By contrast, Germany, France, Spain, and Poland have retained strong appeal, supported by high-quality infrastructure and a skilled workforce, notably in Eastern and Southern Europe.

Sectoral dynamics also reveal shifting contours.[1] Manufacturing FDI has declined in the face of elevated energy costs and uncertain demand, while trade tensions have weighed on software and IT services. Yet not all sectors are retrenching. R&D investment is rising, albeit from a modest base, and services in areas such as logistics, finance, and customer engagement remain robust. According to a recent business survey[2], defense-related investment is also gathering momentum, with European firms ramping up spending in response to geopolitical pressures. Notably, 60% of FDI into Europe originates from within the region itself, often led by small and medium-sized enterprises expanding into neighbouring markets.

Taken together, these trends suggest a structural tilt toward domestic and nearshoring strategies. Hence, EU has introduced series of policy initiatives – spanning regulatory reform and targeted financial incentives – designed to reinforce this shift by boosting internal production capacity and diversifying supply chains in critical areas.

1 - United Nations World Investment report 2025 https://unctad.org/

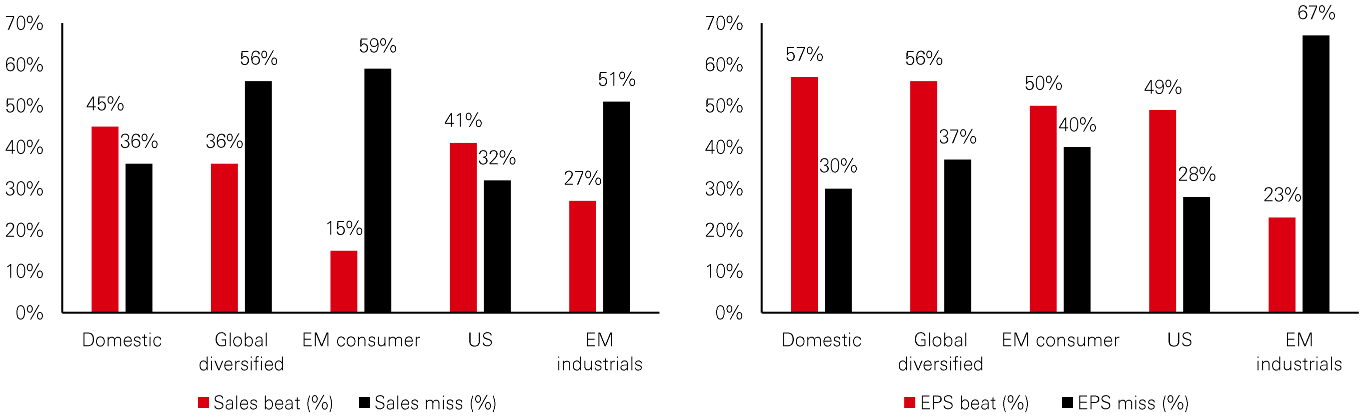
2 - EY report: FDI surveys "Why Europe's confidence persists despite investment at a nine-year low" May 2025 - https://www.ey.com/

Green shoots amid uneven earnings

Shifts in investment flows across Europe are beginning to show up in corporate performance. Europe's second quarter earnings season painted a mixed picture with both fragility and resilience. Broadly, headline earnings rose 4.2% year-on-year, comfortably ahead of flat expectations, even as revenues slipped in line with forecasts. Beneath the surface, however, the picture was uneven. Only half of companies exceeded EPS forecasts – the weakest performance since 2016 – while just over a third managed to surpass sales expectations. Cyclicals outside of financials disappointed, reflecting manufacturing indicators that, though improving, remain in contractionary territory.

European earnings show fragile recovery with cheap valuations leaving scope for re-rating.

Figure 2: Revenue exposure of European companies

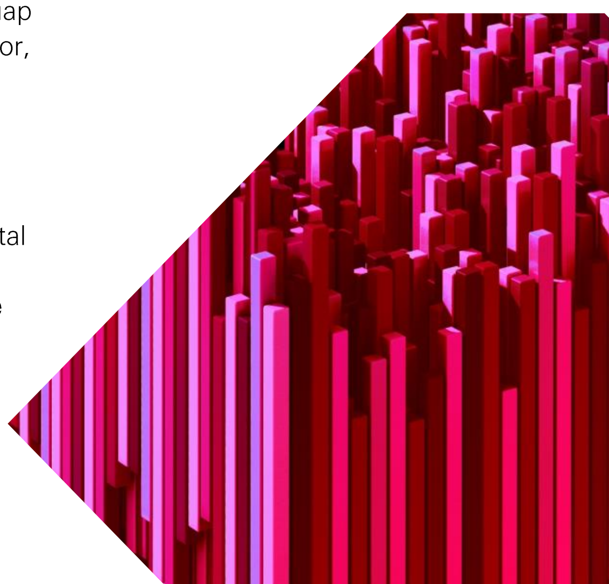


Sources: HSBC AM, Bloomberg, data as of August 2025.

Financials were the clear bright spot. Banks, in particular, continue to benefit from an advantageous rate environment, steepening yield curves, and healthier loan-to-deposit dynamics. Despite their strong run over the past year, valuations remain compelling as banks trade at a 37% discount to the broader market compared with a historical average of 25%. With dividends, buybacks, and earnings momentum, the sector could still deliver attractive double-digit returns. Efficiency gains from digitisation and benign credit costs add further resilience.

Elsewhere, the drag from autos and luxury goods was notable, with sales and earnings plunging by more than 40% and 30%, respectively. Stripping these sectors out, European sales growth would have been positive, and EPS growth would have exceeded 12%, narrowing the gap with the US at 12.4%. Pharmaceuticals stood out as a defensive anchor, delivering 21% EPS growth despite dollar weakness, which was responsible for roughly a third of the region's earnings slowdown.

Domestic-focused firms fared better than those exposed to emerging markets, though US exposed revenues remained resilient. Looking forward, the trajectory of European equities rests on a handful of pivotal factors like stabilisation in luxury and autos, continued strength in financials, steadier currency dynamics, and demand trends across the US and EM. Despite the recent rally, valuations in European equity markets remain low, presenting selective value opportunities.



European fixed income

Relative resilience in credit markets

While equities debate recovery, Europe's fixed income markets have been quietly delivering. Over the past decade, Europe's credit markets have outperformed the US, particularly in high yield. Duration-adjusted performance shows higher Sharpe ratios in European credit, with high yield issuers weathering multiple shocks better than peers across the Atlantic. Even during the defaults of Russian issuers which drove sharp moves, European credit exhibited relative resilience, a testament to more conservative financial policies.

The reasons lie less in growth – Europe's has been sluggish – and more in discipline. European issuers, scarred by years of low expansion, have kept leverage conservative. Inflation, though painful for consumers, has eroded the real value of debt, further supporting credit dynamics. The combination of modest growth, cautious corporate behaviour, and inflation's debt-eroding effect has created an environment where defaults have been contained and returns more stable.

Europe's stronger credit mix has supported superior sharpe ratios versus the US over the last decade.

Figure 3: Rating groups' contribution to IG sharpe ratio for period 31/12/2014 to 31/07/2025

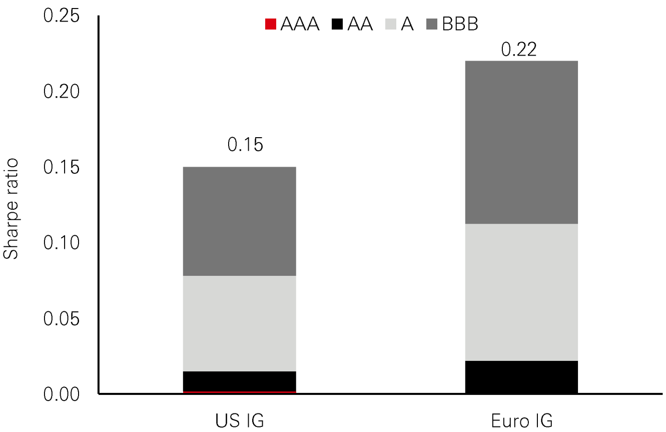
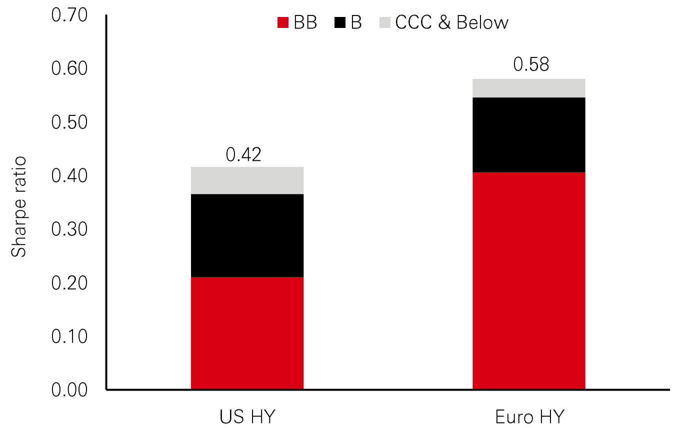


Figure 4: Rating groups' contribution to HY sharpe ratio for period 31/12/2014 to 31/07/2025

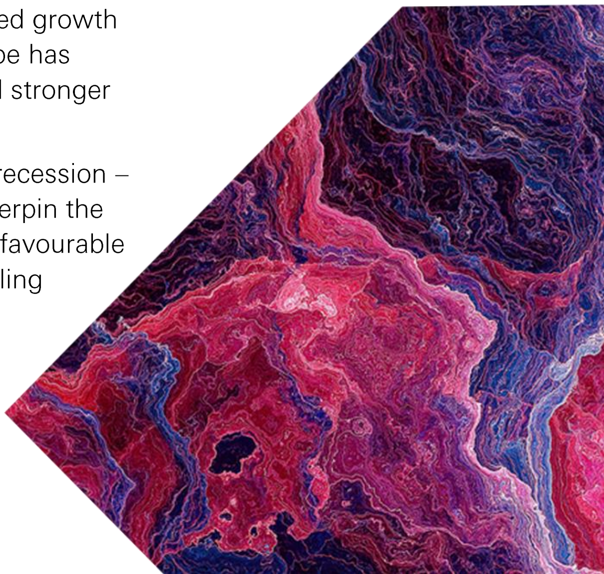


Past performance does not predict future returns.
Total returns hedged in USD for the US and EUR. Returns are duration adjusted as US indices have significant higher durations. The calculation is made with constant duration indices, duration =5.
Sources: ICE indices, HSBC AM, data as of July 2025. Based on the ICE BofA US corporate index (C0A0,) ICE Bofa Euro corporate index (ER00), ICE BofA US High Yield index (H0A0), ICE BofA Euro High Yield index (HE00).

Credit quality differences further bolster Europe's relative strength, particularly in its high yield universe, which has a higher share of BB-rated names – historically the best risk-adjusted performers – while the US carries a heavier weighting of CCC-rated bonds, the weakest cohort.

These structural differences also explain why, despite Europe's subdued growth backdrop, its credit markets have delivered robust performance. Europe has rewarded not through rapid expansion but through lower volatility and stronger fundamentals at the issuer level.

Looking ahead, the resilience of European growth – low but avoiding recession – alongside cautious corporate financial policies should continue to underpin the appeal of Euro credit. For global investors seeking diversification, and favourable risk-adjusted returns, Europe's fixed income markets remain a compelling counterpart to US credit.



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