GENERALI INVESTMENTS

Europe's recovery is booming, but is inflation here to stay?

Mauro Valle, head of fixed income at Generali Investments Partners S.p.A. Società di gestione del risparmio and manager of the GIS Euro Bond fund range, discusses why he is cautious on inflation risk and why the outlook is positive for Italian government bonds.

September 2021

Mauro Valle, CFA

Head of Fixed Income,

- Lead Fund Manager of GIS Euro Bond range
- Over 25 years of experience
- «A» rated by Citywire[1]

Tantrum-free taper…

The European Central Bank's announcement on 12 September that it will slow the pace of its pandemic bond-buying programme in Q4 of 2021 was widely expected by markets, and the reassurance of Christine Lagarde's message that this is a "recalibration" not a taper meant the central bank was able to dial down its level of stimulus without provoking an immediate market crisis.

The ECB will continue to keep the €1.85 trillion emergency program running until March 2022 or later if needed. Its expiration next year will likely be cushioned by the extended asset purchase programme, and any interest rate hikes are expected to be very far off, since many at the central bank believe any upcoming inflation will be transitory and should start to decline in 2022

…but long-term inflation is still a risk

The big question now is whether the current high rates of inflation truly are transitory, or whether long-term rates could be even higher than forecast. Current US annual inflation stands at 5.3% at the end of August, with Eurozone annual inflation at 3% and Germany at 3.9%. These figures are all at ten-year highs.

While some of the current pricing pressures will be due to temporary factors like base effects, the release of pent-up demand, and supply chain bottlenecks during the pandemic, I think there is reason to be cautious about the prospect of higher long-term inflation as well.

For example, the current crisis in logistics and shipping – with many businesses worldwide struggling to meet demand as shipping containers are held up at overloaded ports – may be a sign that supply chain disruption is here to stay. Shipping containers take years to build and at an enormous cost, a dynamic which could exacerbate sustained demand-pull inflation.

Skyrocketing energy prices are also putting upward pressure on inflation. Gas supplies across Europe aren't arriving fast enough to meet demand as economies tentatively emerge from the pandemic, particularly in light of the need to build up winter energy reserves. But the problem of rising energy costs is unlikely to go away. The increasing necessity of decarbonisation is a major factor that could cause further energy price hikes and therefore feed long-term, embedded inflation.

Inflation patterns are likely to be divergent. US growth is likely to cool after a remarkable recovery this year that saw 6.6% GDP growth in Q2, and while headline CPI remains high at 5.3% at the end of August, the few

[1] Mauro Valle is rated «A» by Citywire as manager of the GIS Euro Short Term Bond and GIS Euro Bond 1-3 years sub-funds, as at September 2021.

sectors responsible for the surge (used cars, airfares) are plateauing. I expect inflation and growth to continue slightly higher in the euro area; euro area growth outpaced both the US and China in Q2, business conditions are still holding well, 70% of adults have been fully vaccinated, and inflation continues to rise from 2.2% in July to 3% in August. While concerns remain over the Delta variant's impact over winter, the success of the vaccines should limit further economic fallout, new variants notwithstanding.

What does this mean for euro government bond markets?

Euro government bond markets have generally priced in transitory rather than structural inflation, as well as the tightening and tapering narrative.

However, the ECB's move to extend emergency stimulus contrasts with the US Federal Reserve and the Bank of England, which have both signalled their goal to gradually unwind crisis-era stimulus. US Treasury yields should continue to trend higher despite growth that is set to cool. In the euro area, bund yields are around -0.33% but touched -0.10% in May. Bund yields therefore have some room to rise but this will be limited because ultimately the ECB bond purchases in the last quarter of the year will be larger than supply, so there is no strong monetary force on the horizon for higher euro yields.

The key risk is that an inflation surprise in 2022 causes break-even rates to increase, impacting nominal yields, as real yields – the yield an investor receives after adjusting for inflation – are deeply in negative territory and it's difficult to expect them to fall further. I expect the ECB to remain dovish and support low rates for longer, although we might hear more noise from more hawkish members of the central bank if inflation continues to rise.

Peripheral government bonds remain a bright spot

In the GIS Euro Bond fund range, the portfolios are defensively positioned in order to withstand potential higher yields in the coming months spurred by the economic recovery, higher inflation, and marginally lower bond purchases by the ECB in the future.

Duration across the fund range is short at around a couple of years, and exposure remains heavily weighted towards Italian BTPs and Greek government bonds and to smaller degree government bonds from Spain and Portugal. The fund range is short German bunds and other core countries versus the benchmarks.

Greek and Italian government bonds have led a broad rally in euro government debt since the ECB announcement this month. Italian BTP spreads have performed strongly over 2021 compared to bunds, and volatility has been quite low since the appointment of Mario Draghi as prime minister earlier this year, with spreads moving within a range of only 15 basis points since end of May. This should remain over the coming months as the Italian economy continues to recover, with growth on track to exceed expectations.

As investment managers, we can expect a marginal increase of political noise as Italy approaches the January 2022 Presidential elections but this should be temporary; the prospect of continued supportive fiscal stimulus from Draghi's government remains supportive for Italian BTPs.

Given inflation uncertainty, the portfolios across the fund range are generously exposed to inflation-linked bonds, which have delivered strong performance over 2021. The weighting ranges from 15-25% across the portfolios.

For investors seeking diversification and a hedge against volatility and equity exposure, euro government bonds offer defensive, risk-adjusted returns over a medium- to long-term horizon. The GIS Euro Bond fund range has delivered consistent outperformance versus the benchmark throughout the negative-yielding environment of the past few years, and mitigates the key risks faced by investors who wish to allocate to euro government bonds. We actively manage duration to defend the portfolios against changing rates and our strategy is nimble enough to change as the facts change.

[1] As at 14 September 2021.

Source for all figures: Bloomberg, September 2021

Key features

ISIN (Eur B Acc.)	• LU0145476148 – Euro Bond • LU0396183112 – Euro Bond 1-3 years • LU0145484910 – Euro Short Term Bond
Inception date	• 02.04.2002 – Euro Bond • 04.11.2008 – Euro Bond 1-3 years • 02.04.2002 – Euro Short Term Bond
Benchmark	• JPMorgan EMU Index • JPMorgan EMU 1-3 years Index • EONIA Capitalization 5 D in EU
Funds Currency	Euro
Domicile	Luxembourg
Management fees	0.35%
Performance fees	Not applied
Management Company	Generali Investments Luxembourg S.A.
Investment Manager	Generali Investments Partners S.p.A. Società di gestione del risparmio

Performance analysis | end of Aug 2021

Euro Bond

	YTD	1Y	3Y	5Y
EUR BX Acc.	-0.98%	2.09%	4.28%	2.44%
Benchmark	*-1.92%*	*0.83%*	*3.78%*	*1.63%*

Euro Bond 1-3 years

	YTD	1Y	3Y	5Y
EUR BX Acc.	0.29%	1.04%	1.66%	1.03%
Benchmark	*-0.39%*	*-0.16%*	*0.23%*	*-0.06%*

Euro Short Term Bond

	YTD	1Y	3Y	5Y
EUR BX Acc.	0.62%	0.70%	0.81%	0.28%
Benchmark	*-0.23%*	*-0.34%*	*-0.31%*	*-0.28%*