Navigating the opportunities and challenges facing European Corporate Bonds

Financial markets are pricing in the predictable positive global reflation trade effects. For European investors, however, the road ahead remains rocky as political risks show few signs of abating.

Against this backdrop, corporate bonds may provide a buffer against these headwinds. A valuable ballast to riskier assets, they provide impressive risk/reward benefits.

At Generali Investments, we believe that increasing duration or moving sharply down the rating spectrum will no longer be effective as those solutions will compromise the robustness of the portfolio in the long run, exposing it to unwanted tail risk.

Generali Investments SICAV (GIS) Euro Corporate Short Term Bond Portfolio

The construction of this short term European investment grade corporate bond portfolio relies on the following assumptions. Firstly, the outcome of the upcoming French General Election would be such to exclude extreme left or extreme right parties to win.

Should this be the case, the Eurozone will experience a normalisation process. Secondly, we estimate a total of 3 rates hikes in US in 2017. Those will of course drive up the long end of the curve in Eurozone too. Indeed our macro research is forecasting the 10Y Bund at 0.60% in 12 months' time.

Thirdly, quantitative Easing and the Corporate Sector Purchase Programme (CSPP) are likely to continue as a result of core inflation being tethered to 1%. We forecast that any tapering announcement will not be done before the first half of 2018.

The Eurozone growth rate is forecasted at 1.5% in 2017. Despite some recent downward revision and the fact that there are several geographical differences between the different nations, this is still a good figure. On the liquidity side, conditions and refinancing opportunities are likely to remain as they are.

Our Positioning

We recommend a selective stance on European short term credits, with a couple of caveats.

Firstly, within non-financials we favour the reflation theme and are overweigh sectors such as: basic resources, industrials, cyclicals and real estate, while more neutral on utilities, negative on expensive sectors like automotive and food (consumer staples) or sectors where the debt leverage is forecasted on the upside like telecoms. We also like corporate hybrids as the spread differential with respective senior is quite high.

Moving into financials, we continue prioritising senior legacy bonds that could start to outperform non-financials (a trend that started already in the last 2 months of 2016 as talks about tapering and its impact on non- financial corporates will increase). We suggest avoiding low-steps, or at least be sure that the extension risk is well rewarded. Concerning AT1, we see very little opportunities on this segment in the investment grade (IG) space. We reiterate our long on Swiss banks and insurance bonds that are continuing to prove quite robust and capable of addressing their funding needs and capital gaps. We also favour the development of new segments with different forms of seniority, namely the T3 or non-preferred senior bonds.

The Four Pillars of our Investment Process

We have developed a robust investment process – the four pillars – to effectively navigate challenging market conditions. Each pillar, while providing resilience during volatility, also allows us to undertake asset allocation for alpha generation.

1) Proprietary Research and in-depth Macro-Economic Assessments

This is paramount for setting the top-down macro picture, defining tactical asset allocation, anticipating global market shifts and delivering investment ideas supporting sustainable performance. This process is supported by a 13 in-house macro-research team with proven experience and seniority.

2) Credit Research

At this stage, we define rating migration risks and their possible effects on valuations. We work on reverse-engineering upon portfolio manager request in case of debutant issuers or not-covered names. This team comprises 16 professionals covering investment grade and crossover European issuers.

3) Legal Analysis of Bond Prospectus

Not all bonds issued by the same entity are equal. We thoroughly analyse any covenant, optionality or other contractual obligation that could materially change the cash flow profile of a bond and the expected yield generation.

4) Portfolio Construction

We aim to build up the most efficient portfolio that could at best represent the previous three points and include our major investment convictions. From a quantitative perspective, we base the portfolio construction on Duration Times Spread techniques (DTS technology).

Fabrizio Viola Portfolio Manager, Fixed Income

At Generali Investments', we implement a flexible approach with the use of derivatives which allows us to be more proactive in volatile markets with low liquidity. For us, the best course of action in managing short term corporate bonds is to increase the alpha generating ideas as a percentage of total active risk, decreasing the pure market beta component and targeting as such positive total returns more than excess returns over benchmark. This could be a winning approach at least until we will see a partial normalisation of monetary policies around the globe.

COMPANY PROFILE

Generali Investments (GI) is the main asset management arm of Generali Group, one of the largest and most respected insurance companies in the world with 185 years of providing a solid, stable and highly professional service. With AUM over €450bn, GI is one of the leading European asset managers recognised for delivering consistent results through proven risk-based investment solutions. Active internationally with a strong European presence, GI operates out of 3 main hubs: Germany, Italy & France, with a team of over 400 customer-focused experts with deep knowledge of local markets and asset classes. (Data as at 31.12.2016, source Generali Investments Europe S.p.A. Società di gestione del risparmio).

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