

## We are Yield Hunters

Friday, 03/03/2017

According to our "Yield Hunters", it is not yet time to give up on fixed income, even in this era of negative rates. Indeed, yield curve slopes, a correct dosage of duration and a careful selection from the world of subordinated loans are still available to those who are hunting for fixed income performance.



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*"Instead of being dead, fixed income investments are still offering performance potential. However, it is clear that fixed income investments must be built with a view toward maximum diversification that considers all available tools and possibilities offered by the current market situation."*

It is commonly believed that in a context of low rates there is a high risk of loss on bonds, since interest rates and spreads can only go up. This means, therefore, that liquidity and short-term positions are preferable.

As we see it, choosing liquidity and short-term positions generates high opportunity cost. Actually, in our opinion, the performance that can be achieved is a good deal higher than yields at maturity, because of the curve slope and of this particular macroeconomic environment.

The experience in Japan shows that those who invested in long-term bonds netted better performance by at least 2-3 percentage points, and not just compared to theoretical yields but also against short-term investments. This would be the opportunity cost of giving up on long term maturity. Our suggestion is to keep a little duration risk in your portfolio.

### The scenario in 2017 is 'andante moderato' or moving forward at a moderate pace

It is impossible to talk about fixed income without starting from the macroeconomic scenario, on which trends and yield curve forms are dependent, being central in the generation of performance.

Our central scenario as explained by Fabrizio Quirighetti, CIO and co-head of the multi-asset team, is a continuation of the current moderate growth trend: +2% for the United States, +1.5% for the euro area, +0.5% for Japan and +6% for China. Faced with a growth trend that is not accelerating, we feel that core inflation will remain contained at 2% in the US and 1% in the euro area. Moreover, we see monetary policies that will continue to be expansive or at least less restrictive than currently estimated, with the Fed raising rates no more than twice.

Compared to one year ago, general uncertainty has increased. Therefore, we have assigned a 30% probability that growth will be lower than our expectations and a 15% probability that the scenario will be more optimistic. In any case, we expect a situation where the rising inflation trend should run out in the second half, when the impact of the base effects on oil prices will wear off.

## The point is to anticipate market sentiments

Right now, the markets seem to be focussed on a somewhat more optimistic scenario, with the dollar, rates and oil on the rise, when just six months ago, US 10-Year treasuries were at 1.3%, the Bunds were at -0.2% and the dollar was stable above 1.10 against the euro.

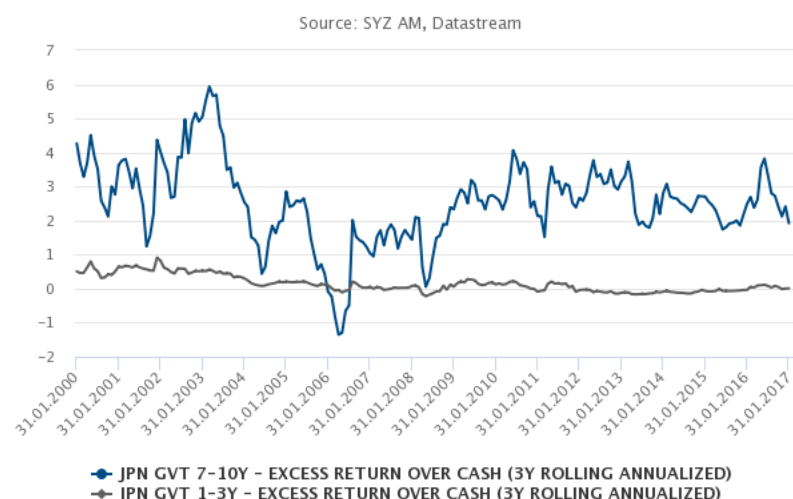
We believe that this optimism is intended to lose momentum over the first half year because we think that the market will continue to fluctuate between deflationary fears (end of 2015) and enthusiasm for growth (end of 2016). This will amplify and project forward the most recent fluctuations in the macro variables, which, instead, in their own right, have shown far less ample fluctuations. In short, the market "creates and prices" cycles, which are not lastingly reflected by macro data. Hence, we feel that the US 10-Year treasuries or the German Bunds could rise in the early months of this year, but not in a structural way. We also expect that in December, they will be at levels not so far from those where they started and still with a positive slope to the yield curves.

There are at least two more points that support our line of thinking. From the standpoint of investors, a further rise of the US 10-Year treasuries would make them extremely attractive among low-risk credit investments, bringing buying flows. From the issuers' standpoint, in a world where debt has exploded over the last few years, no one can afford yields that are significantly and structurally higher.

Last, even the spreads should remain low as concerns credit and government debt, where we expect, nevertheless, a certain amount of volatility due to political risks.

## Chasing for yield

How do you generate performance under such uninspiring conditions? The answer is: in the shape of the yield curves. In terms of rates, the structures are normally sloped positively. If you expect that the yields will not move over one year, you can take advantage of the fact that the life of the bond shortens as time passes. So, a 10-year bond today will be a 9-year bond in 12 months. For example, a 10-year Bund bought at the start of the year at a rate of 0.2% and sold after one year will bring an overall performance exceeding one point (with the curves unchanged). This is quite a bit higher than the theoretical 0.2%, (which instead would be real if held to maturity) and certainly much better than the negative yield of a 3-month investment. The experience in Japan is a great example in this sense. Excluding the shortest periods, with performance nearing zero on short-term investments, total yield on long-term bonds has been higher on average, at between 2% and 3%.



## What if we are mistaken? No worries

As mentioned before, today's scenario has more uncertainty than one year ago. That means that there is no small probability that we may see economies that are more prosperous than expected with the risk that rates continue in the bullish market trends seen in the fourth quarter of 2016.

First of all, even in this case we do not feel that duration is to be feared, since, historically, recovery times for bonds are much faster than one might imagine, being around 3-12 months depending on the bullish cycle considered, against years when stock crashes were being discussed.

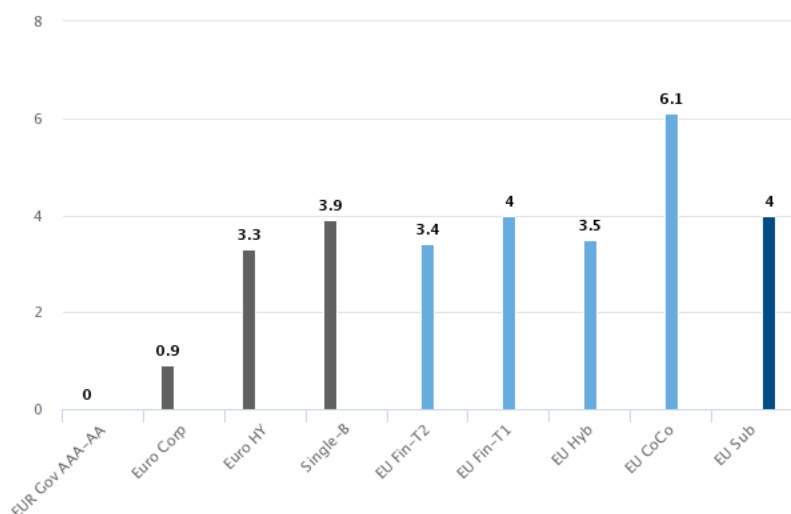
Furthermore, the world of fixed income investments offers a broad range of instruments for diversifying portfolio risk. There is little doubt that among these, credit has taken on a central role in asset allocation in our bond and multi-asset portfolios.

Because of more "rounded" coupons, in the past, corporate bonds have actually been shown to be an excellent "defence" tool at times when rates are on the rise, with performance always better than government indexes. They are less negative when not downright positive, since rises are usually linked to an improved economic outlook.

## Opportunity on the subordinated debt market

Regardless, over the last few years, corporate bonds have shown a stronger correlation with government bonds, while spreads and high yields have been much lower compared to previous experience, risking to be less defensive than in the past. Instead, we feel that the much-discussed subordinated debt can still offer significant investment opportunities.

On average, explained Antonio Ruggeri, the European subordinated debt market is offering average yields of up to 4.1%, nearly the level of the high yield market, but with a decidedly better average quality of issuers, given that those debtor companies' mean ratings are around A-. However, it is fundamental to take great care in the selection of the bonds in this heterogeneous universe, considering the extended dispersion found among yields and spreads and, especially considering the specific risks linked to these bonds. That is why we have developed specific proprietary assessment models to evaluate if those risks are properly remunerated for all of the market subclasses (Tier 2 banking and insurance, contingent convertibles, Tier 1 insurance and non-financial hybrids). This is a 640 bn euro market (over an overall 3,300 bn in European corporate bonds) where 66% is represented by banks and 30% by bonds with a speculative rating, but also where only 5% of issuers are not investment grade.



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