Peripheral European government bonds remain attractive despite volatility

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Mauro Valle discusses the recent turbulence in bond markets and explains why, despite the current volatility, Italian and peripheral government bonds remain an attractive way to maximize risk-return.

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Central banks double down to fight inflation

It has been a tumultuous week for global fixed income markets, after major central banks hiked rates sharply to combat inflation. After stronger than expected US inflation data, the Federal Reserve hiked rates by 0.75% and the market is expecting rates to end the year at around 3.25-3.5%.

The key risk is that steep hikes will lead to a repeat of the 2018 global sell-off of risky assets and an economic slowdown, as demonstrated by the noticeable tightening of financial conditions in recent weeks. The US 10-year Treasury yield, an economic bellwether, touched 3.5% before the last Fed meeting, raising the risks of a Fed-induced recession. The upward movement was fully driven by real rates (nominal rates minus breakeven rates), which reached 0.81% before retracing to 0.60% area. Breakeven rates declined to a four-month low and stabilised at around 2.6%, reflecting the Fed's determination to keep inflation expectations under control, albeit accompanied by a weaker growth outlook.

Given the Fed is willing to risk a recession to fight inflation, the yield curve should invert as markets price this in. The next move is expected to be a hike of 0.5-0.75% and the market's pricing for December is close to the Fed's "dot plot" level of 3.5%. If the US economy remains resilient, US Treasury yields should break the 3.5% mark, reflecting a possibility that Fed rates will rise to 3.75-4.00% in 2023.

The Fed is committed to fight inflation but is also aiming for a soft economic landing. I expect that the cooling of the economy and lower inflation in the second half of the year will lead the Fed and other central banks to a slower pace of tightening compared to actual market pricing.

Turning to the Eurozone, we probably have not yet seen the peak of inflation. At their last meeting, the European Central Bank decided to take a strong stance to regain credibility in managing inflation expectations. After the announcement of a 0.25% hike in July – the first rate hike in eleven years – the ECB will probably hike another 0.50% in September and then reassess the situation. Markets are expecting rates to end the year at 1.75%.

In response, 10-year German Bund yields touched 1.80% before falling to 1.6% after the ECB's announcement of an "anti-fragmentation tool", which will aim to manage the divergence of borrowing costs across Eurozone countries. European real rates increased up to -0.37%, returning to the peaks observed in the pre-Covid period. With this sharp rate repricing, financing conditions have tightened too much and too quickly, raising the risk of a recession, particularly considering the risks from the war in Ukraine (ie gas cuts).

Markets are now waiting to see at what point Bund yields will stabilize. After summer, inflation data and the resilience of the European economy will determine further moves in yields, as will additional policy details from the ECB.

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Staying exposed to Italian and peripheral government bonds

As in the US, the main risks for European markets are an economic slowdown and higher energy prices due to the war in Ukraine.

In recent weeks, the Italian BTP-Bund 10-year spread widened up to 240 basis points driven by the risk-off sentiment and the hawkishness of the ECB. Spreads retraced after the announcement of the anti-fragmentation tool by the ECB and came down to 190 bps. We expect the spread to hover around 200 bps as markets wait for more details, probably at the ECB's next meeting on 20-21 July.

Compared to the spikes in yields in 2018 and 2020 which were due to political instability and lockdowns respectively, concerns about absolute rates and debt sustainability are driving the current moves.

On this front, the economic outlook is more constructive than previous periods in the last decade. Italian nominal growth should be resilient over the coming quarters, the country's financial discipline is assured by Draghi government, and the EU Covid-19 recovery funds continue to provide support worth 12.5% of GDP over five years. In this scenario Italy's debt-to-GDP ratio will be under control, despite higher financing costs. Moreover, the banking sector benefits from much stronger capital cushions, higher profitability and a clean-up of bad debts, compared to the situation we saw in the Eurozone debt crisis a decade ago.

Bund spreads for French, Spanish and Portuguese government bonds have also widened due to risk-off sentiment. French bonds are widening over the 50 bps levels and Iberian countries over 110 bps.

Greek spreads widened up to 295 bps, before coming back to 225 bps; expectations remain encouraging as Greece has no need to issue bonds yet and the rating trend is expected to be positive in the next quarters,

After the 2-10 year German Bund spread steepened and reached 80 bps, the curve flattened by 20 bps due to higher short-term rates and stable 10-year rates. Over the next few months I expect the flattening trend will continue as the ECB will hike rates – like in the US over recent months – especially if Bund rates stabilize.

Generali Investments SICAV (GIS) Bond Funds: Active and defensive exposure to European government bonds

The portfolios in the GIS Bond fund range entered the year defensively positioned in order to mitigate higher yields. This lead to the fund outperforming the benchmark in the first half of the year. Our view was that higher yields were likely due to the economic recovery, higher inflation, and marginally lower bond purchases by the ECB. The unexpected war in Ukraine exacerbated the supply chain and energy disruption that already existed. Given the uncertainty, we entered the year with generous exposure to inflation-linked bonds at 15-25% across the portfolios. These have performed well this year and took profits on the position in recent weeks as we observed signs that breakeven rates were stabilising. We maintain around 10-15% exposure to inflation-linked bonds across the funds given the risk of further energy prices driven by the ongoing war in Ukraine.

We entered the year with short duration across the portfolios at a couple of years. Our key exposure remains long 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.

After the moves last week, we reduced duration in the portfolios to neutral levels. We took advantage of increasing long Italian BTP exposure when spreads were at their widest and then cutting this exposure by one third following the ECB meeting when they benefited from positive performance.

In my view, the recent movements in European yield curves have been overly steep, especially in peripheral countries, therefore presenting an attractive entry point for short-medium Italian and peripheral government bonds. The main risk is further flattening driven by central bank hikes, so to exploit this steepness we favour playing spreads between maturities (for example, 2-5-year BTPs spreads) and to manage overall duration with exposure to the long end of the curve to enhance convexity.

Outlook

Looking ahead to the second half of the year, the recent peaks of volatility may resurface in the lead up to the ECB's July meeting, driven by speculation on what certain policies such as the anti-fragmental tool might hold. However, I expect lower volatility in the second half of the year, as the path of central bank decisions will become clearer and the impact on the economic scenario, as well as from the war in Ukraine, will be less uncertain. Breakeven rates should further stabilize due to the ECB's commitment to tackle inflation. Nevertheless, the ECB faces a challenging time ahead and a recession, even if mild, cannot be ruled out.

For investors seeking diversification and a hedge against

against volatility and equity exposure, after the rise in yields, euro government bonds can be considered a defensive, risk-adjusted investment over a medium- to long-term horizon.

The Generali Investments SICAV (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.

Source:

[1] The Company full legal name is Generali Investments Partners S.p.A. Società di gestione del risparmio.

[2] Mauro Valle is rated «AAA» by Citywire as manager of the GIS Euro Short Term Bond and GIS Euro Bond 1-3 years sub-funds, as at June 2022. (LINK)

Key features

ISIN (Eur B Acc.)	LU0145476148 – GIS Euro Bond LU0396183112 – GIS Euro Bond 1-3 years LU0145484910 – GIS Euro Short Term Bond
Inception date	02.04.2002 – GIS Euro Bond 04.11.2008 – GIS Euro Bond 1-3 years 02.04.2002 – GIS Euro Short Term Bond
Benchmark	JPMorgan EMU Index – GIS Euro Bond JPMorgan EMU 1-3 years Index – GIS Euro Bond 1-3 years EONIA Capitalization 5 D in EU – GIS Euro Short Term
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
Risk level SSRI	**3**/7 – GIS Euro Bond **2**/7 – GIS Euro Bond 1-3 years **2**/7 – GIS Euro Short Term Bond *For further details about the risks, please refer to the KIID available on our website*

Source: Generali Investments Partners S.p.A. Società di gestione del risparmio as of 31.05.2022. **Past performance provides no guarantee for the future. No express or implied liability or guarantee is assumed that the future performance will correspond to the performance described above. The value of and income from fund units or sub-fund units ("Units") may rise or fall. No guarantee can be assumed that the investment objectives of the fund will be achieved. The performance of and income from the Units have to be reduced by costs and taxes.**
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