For professional investors in Italy, France, Austria, Germany, Spain, Portugal, and Luxembourg

A PRIME TIME TO LOCK-IN HIGH QUALITY CORPORATE BOND YIELDS

NOVEMBER 2023

Views from across the Generali Investments ecosystem

The normalization of interest rates and more resilient inflation than expected have made bonds more competitive than equities for the first time in 15 years but, with risks of a slowdown increasing, credit selection is more important than ever. In light of this, four corporate bond managers from the Generali Investments ecosystem share how they're managing macro uncertainty, and where they're finding opportunities and avoiding pitfalls.

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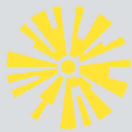

aperture investors

SIMON THORP
CIO of Corporate Credit, Aperture Investors

…a substantial 200bps spread widening is needed for bonds to reflect "fair value"

GLOBAL LONG-SHORT CREDIT

A looming tipping point for global credit

One of the early surprises of 2023 was the resilience demonstrated by developed markets. This unanticipated strength fuelled a rally during the first nine months of the year, particularly in weaker credit segments.

However, the combination of continuously increasing rates and the time lag since the first hike has brought many economies to a tipping point. We think that the rally of 2023 could reverse quite swiftly. We would point to a recent parallel in equity markets, where European equities shed 50% of their year-to-date gains in a mere seven weeks, as illustrated by the Euro Stoxx 50 index. At the time of writing, investment grade credit has slipped into negative territory, and high yield bonds have surrendered roughly 40% of their year-to-date gains.

Looking ahead, we find it encouraging to see more spread dispersion over the past 2-3 months and we believe this will continue.

As the landscape evolves, we believe certain sectors are poised to experience shifts. Pro-cyclical sectors such as chemicals, building materials, retail, and autos are anticipated to face challenges. Conversely, sectors that have historically been defensive during bear markets, including financials, energy, technology, media, and telecommunications, gaming, and healthcare, hold the potential to provide positively convex alpha opportunities.

There is a substantial maturity wall in the high-yield and leveraged loan sectors on the horizon, spanning from 2024 to 2026. The cost of capital has escalated to levels that could pose challenges, particularly for businesses with weaker financial standing. In our view, this should provide a rich source of long and short global credit opportunities in 2024.

Should macroeconomic conditions deteriorate from current levels, potentially impacting company revenues, liquidity could both dry up and become highly selective. Default rates are already on the rise, notably in the US (approaching 5% compared to the less than 2% observed in 2022). Credit spreads are only beginning to factor in this evolving dynamic.

Absolute yield levels for investment grade and high yield continue to be attractive in our view, with the potential to become even more so. However, credit spreads remain remarkably tight from a historical perspective. To align with historical levels and account for increasing US default levels approaching 8-10%, we perceive that a substantial 200-basis-point spread widening is needed for bonds to reflect 'fair value.'

With central banks unlikely and perhaps incapable of rescuing markets with rate cuts (which would spur already stubborn inflation) and stimulus (current sovereign debt/GDP levels are already too high), we feel that maintaining defensive positioning in global credit is wise for the foreseeable future.

Clearly, recent events in the Middle East add to the geopolitical headwinds that markets are already facing. As with any military conflict, uncertainty becomes heightened. At the time of writing, markets have reacted calmly and logically. We think that any escalation will manifest itself initially through the energy, currency and government bond markets with co-incidental falls in equities and widening in credit spreads. With an already defensively positioned strategy, we do not envisage making many changes, though we may opportunistically add to OTM put options if volatility declines.

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Plenisfer INVESTMENTS

MAURO RATTO
Co-Founder and Co-Chief Investment Officer, Plenisfer Investments

> We favor crossover credit, which straddles investment grade and high yield

GLOBAL UNCONSTRAINED MULTI-STRATEGY FIXED INCOME

Combing the globe for mispriced opportunities

The normalization of interest rates and more resilient inflation than expected has made investing in bonds more competitive than equities for the first time in 15 years. While spreads are moderate, we believe that the best opportunities lie in combining global credit risk with short- and medium-term rates.

In our strategy, we blend corporate credit exposure with other fixed income opportunities. Our approach allocates by strategies rather than asset classes – we call this approach the "new active". Our three strategies are macro (which reflect our view of the world), income (to generate carry) and special situations (to provide uncorrelated returns). With this approach, we aim for each investment to support long-term total return goals, short-term returns, and/or to provide optimal portfolio diversification.

Overall, we view European corporate debt as good investment opportunity. Companies with high creditworthiness boast quality balance sheets with moderate leverage, making 2023 an exceptional year for European banks so far. Investment grade spreads are modest, while high yield offers attractive spreads but comes with increasing default risk in the current end-of-cycle economic situation. We therefore favor crossover credit, which straddles investment grade and high yield. We invest along the capital structure, selectively buying subordinated debt of investment grade issuers, particularly in the telecommunications and energy sectors, which exhibit strong cash generation profiles.

In terms of sectors and themes, we are currently finding diverse opportunities across corporate credit, from recovering industries to mispriced securities and sectors. We view oil & gas as a particularly robust sector characterized by strong cash flows and solid balance sheets among key players. While senior oil & gas debt offers relatively modest yields (around 3.7-3.8% in euros), hybrid instruments within these companies can offer much higher yields (ranging from 5.8% to 6.6%) and are typically callable at the first call date.

We have found a host of mispriced opportunities in the airline sector. The industry is on the path to recovery following the liquidity crisis in 2020. These bonds can offer outsized yields, with senior secured collateralized paper backed by assets worth several times the issued debt. Several airlines have restructured their debt and improved their balance sheets; while some European airlines are moving closer to investment-grade status, but offered yields ranging from 5.5% to almost 7%.

Real estate has also faced challenges, particularly in the office space segment, due to the pandemic first, then rising interest rates and economic uncertainties. Nonetheless, the logistics segment has emerged as a resilient and robust subsector.

Insurance is another sector facing challenges but one where robust credit analysis may pay off: there are strong European insurance issuers that offer investment grade instruments with higher yields than expected, due to their association with a weakening sector.

Finally, we are managing interest rate risk at the moment by focusing on short- and medium-term credit, especially considering the inversion of yield curves, particularly in the US where we will progressively add duration.

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EUROPEAN INVESTMENT GRADE

Resilience amid uncertainty for European IG

FABRIZIO VIOLA
Portfolio Manager,
Generali Investments Partners

Many companies, especially those with high credit ratings, have already pre-funded their liquidity needs

The macroeconomic backdrop has provided significant support to European corporate bonds thus far. Even low-rated and high-yield instruments have exceeded expectations, thanks to a light supply and the absence of major credit events. This has bolstered the carry trade throughout 2023, a year in which the primary market has also been well absorbed, and credit fund flows have turned positive once again.

Nevertheless, new interest rate levels cannot be ignored when it comes to investment decisions due to their clear impact on the cost of new debt. Higher interest rates could affect equity valuations and potentially put highly-leveraged companies in distress. However, while it's true that fundamentals are deteriorating, this is at a very slow pace. Many companies, especially those with high credit ratings, have already pre-funded their liquidity needs. While pockets of risk remain, they are limited to a few real estate companies in the Nordics, where many have taken significant measures to ensure the repayment of their debt until early 2026.

This means that the resilience of credit can only be jeopardized by a sharp increase in systemic risk – a kind of irrational sell-off phase that can be triggered by various factors, ranging from policy mistakes to individual corporate failures.

The most critical factor to monitor in this regard is when the profit/growth cycle effectively turns negative. Currently, we have not reached that point, at least not until the US economy weakens significantly.

We are managing this risk by adopting a cautious approach to portfolio construction. We aim to select companies that are best positioned to weather this new interest rate environment and that can reduce leverage to offset higher interest expenses, keeping interest coverage ratios nearly constant. Additionally, we are maximizing our carry component to benefit the most from a range-bound spread environment. Our top credit picks include senior financials, callable Tier 2 bonds priced at maturity dates, and corporate hybrids of companies with minimal risk of downgrades at the senior level.

We also give considerable importance to bond technicals and pay close attention to legal elements and covenant analysis to identify mispricing or real opportunities. While the rise of systemic risk may not be imminent, we are managing it by maintaining a neutral interest rate duration and implementing tactical hedges using credit derivatives. In particular, we employ a protection trade on the iTraxx Crossover index, which represents the high-beta segment of the credit landscape.

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STANISLAS DE BAILLIENCOURT
Head of Investment Management, Portfolio Manager, Sycomore

> With our strong requirements in terms of sustainable investment (...) we were able to avoid some of the riskier corporates

SOCIALLY RESPONSIBLE CREDIT

Seizing opportunities in responsible credit

Rates have reached levels not seen for over a decade on the back of persistent core inflation, pushing central banks to hike more than what markets expected. This "higher for longer" rate environment can also offer interesting investment opportunities, with real rates now in positive territory.

Markets have been looking for a recession since mid-2022. Penciled in for the start of 2023, it has been systematically pushed back. Despite the sharp monetary tightening implemented in developed countries, economic conditions have been more resilient than expected. Fiscal stimulus, notably in the United States, has partly mitigated the impact of interest rates hikes. Corporate earnings publications even came in better than expected for the first half of the year, with companies reporting high margins. On the downside, the Chinese economy is recovering at a weaker pace than anticipated, despite various stimulus measures.

Since the beginning of the year, we have favored mid-dated bonds – between two years and five years maturity – and preferred quality intermediate credit, such as crossover BB ratings, which offer interesting value. Together with our strong requirements in terms of sustainable investment and the various SRI labels – Towards Sustainability (Belgium), Umweltzeichen (Austria), France's SRI label, FNG (Germany) – we were able to avoid some of the riskier corporates that were challenged this year.

Primary markets are also reopening with attractive pricing and a growing number of Sustainability Linked Bonds (SLB), showing issuers' commitment to improve their ESG profile.

Looking into the end of the year and 2024, we are beginning to seize opportunities provided by higher rates and attractive credit spread levels, hence investing in longer dated bonds to lock-in current yields for a longer period. We are on the brink of a major turning point. In addition, we have increased the weight of BBB bonds at the expense of high yield.

Lastly, we are witnessing a growing interest from investors for fixed income, which is also reflected in the increase in flows in target maturity funds.

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