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Portfolios, a prudent approach to European bonds

In a situation where rates are normalising, the preferred option should be frontier countries' government bonds, which are still showing double-digit yields at maturity.

After 2016 ended on a positive note for the bond asset class in general, how will this year go and what would be ideal portfolio consist of? In a world of unknowns, the general idea is that rates won't shoot up in the short term. "We don't believe there will be a big rise in rates", observes Riccardo Milan, partner of advisory firm Capital Strategies Partners. We're more likely to see a slight normalisation, even though the results of the forthcoming elections in Europe could influence the markets". In the light of these considerations, Milan says he prefers "frontier countries' government bonds (in which to invest through funds) which, even with the +11% seen last year, are still showing double-digit yields at maturity. We think it's also worth investing in European senior loans: in addition to having yields of 5%, they're variable rate and so are perfect for an eventual rise, even a modest one, in rates. Lastly, we'd suggest keeping investment in traditional euro and US government bonds, and exposure to high-yield securities, especially long-term products, as low as possible". Francesco Castelli, head of fixed income di Banor Capital, also urges prudence on government bonds, especially European ones, given the possibility that "the shift in the expected five-year inflation scenario towards the ECB target might not support the continuation of an ultra-expansionary approach".

Yields are negative for short-term European bonds, while for long-term products they are still very low "and in the future there's a risk of losses", says Castelli. While Cahestelli recommends underweighting government bonds, Castelli suggests that investors overweight European credit. Unlike Milan, he sees high-yield securities in a positive light:

"We advise investors to focus on good quality high-yield securities which offer a decent return: we have a low-risk portfolio, with an average BB rating and yields of 3.5-4%". In the United States, where the Fed rise in rates has already been factored in, "you could also opt for a longer duration.

We don’t, however, see any major upside in foreign exchange asset allocation”, even though there are interesting emerging currencies such as the Mexican peso. “But these are highly volatile investment choices that should be kept to a very limited part of portfolios”, concluded Castelli.

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CHART	**Preferred bonds**
Candriam	Short-term securities from the euro area with enough of a yield buffer to offset the effect of a rates rise and currency hedging; New Zealand short-term bonds with yields of over 2%; short-term US IG bonds; the 1-3 year segment.
Banor Capital	European corporates, especially good quality high-yield BBs with yields of 3.5-4%; securities in under-valued emerging currencies like the Mexican peso, for a very limited part of the portfolio.
Capital Strategies Partners	Government bonds of frontier countries (through investment funds); European senior loans.