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Fondi & SICAV

Changes in credit trends are hard to predict

Fondi&Sicav's survey of euro-denominated high-yield bonds continues. Today it's the turn of **Francesco Castelli**, **head of Fixed Income at Banor Capital** and manager of the Banor SICAV Euro Bond Absolute Return fund.

by Stefania Basso

In the last few months, the asset class of euro-denominated high-yield bonds has continued to provide satisfactory income flows and stable prices. What factors have underpinned this trend?

The growth of the high-yield securities market has taken rates in this asset class to historically low levels: today the entire European index offers, on average, yields of less than 3%. A record, for companies that were once labelled junk bonds. Even if you adjust for the low level of government bond rates, the spread (in other words the risk premium offered by this type of investment) is close to the minimum seen in 2007, just before the crisis erupted. The fact that these levels – in our view excessive – have been reached can be explained by a combination of favourable effects: improved economic fundamentals on the one hand, and a speculative bubble caused by hyper-expansionary monetary policies on the other. The central banks have flooded the market with liquidity, lowering reference rates and actively buying debt instruments. This has crowded out investors, who have progressively been forced to increase their levels of portfolio risk by focusing on increasingly long-term securities (duration risk) or increasingly low-quality credit (credit risk). Experience tells us that this behaviour is typical of the last stages of a bull market for credit. And, if memory serves us well, credit cycles have the terrible vice of making abrupt and violent U-turns. Our instinct now, as prudent investors, is to exercise the virtue of patience and make the most of the rises in the market to lighten our positions and prepare for a period of volatility in which opportunities will once again emerge.

What factors might raise doubts as to the favourable scenario for this asset class? Could the European Central Bank's next announcement on tapering be the start of an adverse period?

Changes of direction in credit are particularly hard to predict. It's difficult to identify macroeconomic variables that provide reliable pointers. One of the few indicators that really does work, however, is the change in the amount of money injected into the economy by the central banks. Credit spreads will react to the central banks withdrawing from their quantitative easing policy (irrespective of the rates level). The ECB's tapering policy is the highest-risk scenario for the coming months. We believe that in this scenario, our caution will be amply rewarded: the ECB's withdrawal will affect not just prices, but also the way the market operates, with selling becoming more difficult. An opportunity for people who, like us, will arrive at that stage with plenty of cash ready to be invested.