15 April 2019	L'Economia CORRIERE DELLA SERA	extract from page 50

If Treasuries Predict a Storm, Take Notice: They Don’t Get it Wrong

Banor Capital Francesco Castelli, Bond Manager

European banks are much more stable.
Subordinated debt offers well over 5%, but this comes with increased complexity

There is a clear contradiction in the way stocks and bonds seem to be interpreting the current economic scenario. The major stock market indices are close to the highs of October 2018. “Considering the slowing of earnings observed in the last season of quarterlies, valuations are counting on an improvement in the situation. They see everything as rosy, but they aren’t considering the risks. The bond markets, on the other hand, are issuing a clear warning signal”, observes Francesco Castelli, Banor Capital Bond Manager.

The American interest rate curve has inverted, with the two-year yield several times above the ten-year yield. This phenomenon often precedes a recession or significant economic slowdown, with inevitable impacts on profit dynamics. Usually, explains Castelli, during the next six to twelve months, there will be a strong stock correction.

Who is right? Have the stock markets returned to being overly positive following the collapse of December or are government interest rates pricing in excessive negativity? “Looking at historical data for recent decades, stocks have a greater predictive capacity when trying to recognise signs of a global recovery. But, at this point in the economic cycle, we should be paying attention to bonds”, concludes the Banor Capital manager.

“The trend in the yield curve has always been the best indicator prior to a recession”.

Meanwhile, the German Bund has returned to 2016 levels, when interest rates were negative up to the ten-year maturity. And euro zone bonds incorporate forecasts of growth in consumer prices well below the 2% set by the ECB as a priority target. We therefore return, after a long break, to speaking of the Japanisation of Europe, towards a deflation spiral. “In this type of environment, with rates at zero, defensive credit strategies work that do not include excessively low ratings. Amongst issues with BBB or BB+ ratings, there are interesting securities to be found. This is particularly true in cyclical sectors, with yields between 2% and 3% for three to four-year maturities”.

The other area of opportunity is the financial sector. “European banks are much more stable compared to a few years ago. The regulatory maze will lead them to return to the market with significant new funding programmes to further strengthen their capital requirements. This can be a problem for stocks, but from a bond investor's perspective, we can feel more at ease”. It is true that the cost of funding for Italian banks is higher, as it is influenced by the BTP-Bund spread and because the burden of non-performing loans is heavier compared to other countries, despite notable disposal efforts in 2018.

It is also true, explains Castelli, that the deterioration in the macro scenario over four or five quarters is destined to drive a further increase in bad loans. “However, the more flexible attitude demonstrated by European institutions towards Italy and liquidity programmes initiated by the ECB (TLTRO) work in our

favour. Particularly amongst subordinated bonds, we find attractive yields, above 5%. These price in excessive negativity due to the fact that, in the previous cycle, banking was amongst the most heavily penalised segments. This prejudice may be justified on the stock front, but not for bonds”.
Those investing in subordinated securities must, however, accept high levels of complexity: “This is a very difficult segment to analyse. There are significant differences not only between issuers, but also between individual issues from the same company. This is still an area where analysis pays”.

Pieremilio Gadda