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SPECIALIST INVESTMENTS

Rising rates? Now is the time for high yield bonds

by Chiara Merico

High yield bonds could be an attractive investment opportunity in a time of rising interest rates. We talk about this with **Francesco Castelli**, head of bonds at **Banor Capital** and manager of Euro Bond Absolute Return, a low duration mid-yield fund focused on the European credit market.

WHEN INTEREST RATES RISE, THE ASSET CLASS THAT INCLUDES COMPANIES WITH FRAGILE CREDIT IS THE ONLY ONE TO GIVE PROTECTION

Is there interest rates risk in this context?

The question I'm always asked as a bond manager is, "What happens if rates go up?". The product I manage has a very low exposure to interest rates. With rates rising, the fund has moved little or gained.

This was in the first few months of the year, when it was a very difficult for the bond market, especially government bonds. Our product segment, high yield, is one of those that has managed to survive. The history of bond markets shows that, when interest rates rise, there is an adverse effect on government bonds. Rising rates mean falling bond prices. The downturn in government bonds is followed by the same in corporate investment grade bonds and inflation-linked securities. The only asset class that survives is the high yield sector, which includes the companies with the most delicate credit situations.

What are the reasons for this?

High yield has a positive correlation with equities but is not correlated with government bonds. This is because times of rising interest rates are also times of economic expansion, and high yield bonds perform better during these phases. That's why we see rising rates as an opportunity, even though bond investors usually equate them with loss. It is especially opportune for us, since we have a portfolio of high yield bonds with very short durations, never more than three years. Our investment style means that we have a double hedge against rising interest rates.

What are the risks of this kind of strategy?

Our portfolio is sensitive to economic recessions, which we are not seeing at the moment. In fact, a recovery scenario seems likely. Then you have to consider the behaviour of central banks. History shows that there were about ten instances when rising rates had a positive effect on high yield. The two major exceptions were in 2013 and 2004, when overly aggressive central bank behaviour created pressure on the credit side. In 2013, it was the famous "temper tantrum", and in 2004, it was a rate hike that the markets didn't see coming. The central banks, including the Federal Reserve, don't want to repeat this mistake and are quite openly staying behind the curve. The banks are forecasting no change in interest rates even in 2023—despite market predictions of an increase at that time—because they want to structurally lag behind the market. This is to boost inflation. The expectations are for an increase, but the central banks believe it will be short term, so the Fed and the ECB have to keep on stoking the fire of inflation.

So what is the emerging scenario?

The only fixed income segment that has seen positive returns since the beginning of the year is high yield. The conclusion is that, even in the future and with rates continually rising, the only way to preserve capital in fixed income is to focus on credit.