

Candriam Bonds Euro

Market Overview

European bond markets saw mixed performance in February as US inflation and labor market data again surprised on the upside. Against this backdrop, central bankers in the US and Europe signaled that they want to see more evidence that inflation is on track to reach their inflation target on a sustainable basis before starting their easing cycle. As a result, market expectations regarding the first rate cut have been pushed back towards June compared to March at the beginning of the year for both the Fed as well as the ECB.

In the eurozone growth expectations remain low, but we have seen some modest improvements in data recently. The February composite PMI increased to 49.2, driven by services. On a country level we saw a large drop in Germany while data improved in the rest of the Eurozone. On the inflation front, data decelerated further in the eurozone, driven by energy and food with headline standing at 2.6% YoY. Core inflation decelerated (3.1% YoY), but proved more resilient while services also remained sticky at 3.9%.

On the monetary front, ECB members appear to converge towards June for the first rate cut while they continue to closely monitor wage developments in the eurozone to have a better view on the medium term inflation outlook. The Fed from its side has more leeway given the resilience of the US economy.

The property crisis rippled across the world as Chinese investors, needing to raise cash amid a deepening crisis at home, offloaded assets in Europe and the US at significant discounts. The turmoil, for now, remains concentrated around smaller and regional banks, with New York Community Bancorp, Japan's Aozora Bank Ltd. and Germany's Deutsche Pfandbriefbank AG in the spotlight as they took steps to brace for bad loans. The deepening real estate crisis prompted fixed income investors to become more reluctant to add exposure to lenders that are exposed to commercial real estate and has driven an increase in the issuance of covered bonds.

Regarding primary issues, we observed strong activity for Non-Fin corporations whose EUR-issuance volume is more than 20% higher than the level recorded at the same period last year while for Financials, volumes dramatically decreased after a hectic start to the year.

In terms of market evolution, German 10 yr yields increased to 2.41%, while Italian and Spanish 10 yr yields ended the month at respectively 3.84% and 3.29%. In terms of yield curve, we saw some flattening of the curve. Excess return was again positive for Euro IG credit, despite a weaker end of the month. Performance-wise, real estate, insurance and banks were again among the better performing sectors.

Portfolio Highlights & Strategy Review

In February, the fund generated a performance slightly above the benchmark. Our overweight on credit, SSA and EE contributed positively while duration and curve were negative drivers. We initiated a long duration bias as 10-year yields turned back above 2.3% while we kept our steepening bias on the 10-30 year part of the curve. Country-wise, we kept an underweight stance on France and Belgium preferring exposure to Austria among core peers. We increased our exposure on Luxembourg via a 10-year primary issue. Among non-core countries we favour EE countries. On Italy we favour corporate exposure relative to sovereign exposure. On credit we maintained our constructive stance and were active on the primary market with still a more important bias on financials vs non-financials. Among non-financials, we favour telecoms, healthcare, Personal & Household Goods while we remain defensive on the Oil&Gas and Construction&Materials sectors. We remain overweight on SSA, as we continue to see potential for swap spread tightening.

Fund Outlook

We closely monitor geopolitical risks and its economic impact, inflationary pressures, financial stability and the evolution of monetary policies of major central banks. These are likely to remain the key drivers and the uncertainty surrounding them will likely drive volatility. In terms of monetary policy, most major central banks are at the end of their tightening cycle and should bring first rate cuts forward in Q2-Q3, as inflation should continue to decelerate. We keep a constructive view on IG credit as absolute yield levels remain interesting and fundamentals are resilient. We remain more prudent in relative terms towards high yield, especially the lower ratings given the economic backdrop. In terms of issuer selection, we count on our rigorous in-house bottom-up and ESG analysis, as selectivity should be important as there will be more dispersion. On the political front it will be important to monitor the outcome of the elections in Portugal.

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