Monthly commentary / 30.8.2024

Vontobel Fund – TwentyFour Absolute Return Credit Fund

Marketing document for institutional investors in: AT, CH, DE, ES, FI, FR, GB, IT, LI, LU, NL, NO, PT, SE, SG (Professional Investors only).

Investors in France should note that, relative to the expectations of the Autorité des Marchés Financiers, this fund presents disproportionate communication on the consideration of non-financial criteria in its investment policy.

Summary

— August was a highly volatile month for fixed income and equity markets. At the beginning of the month, the US labour report sparked recessionary fears and prompted negative market sentiment. However, these concerns were quickly offset by strong economic data showing the US economy was still performing well. In the UK, the Bank of England delivered its first interest-rate cut in four years. In Europe, headline inflation was at its lowest level for three years, opening up the potential for an interest-rate cut next month.

— With a steady backdrop for rates and credit, despite some equity volatility during the month, the Fund returned +0.54%, net of fees. This takes the year-to-date returns to +4.26%, some +79 basis points (bps) higher than the 1-5Yr Sterling Corporate Index.

— With the European Central Bank having delivered the first rate cut for this cycle in June, and with the Bank of England following suit on 1 August, it is likely that the US Federal Reserve (Fed) will also cut in September after recent dovish commentary. In summary, we believe the combination of low duration and high average yield, with high average credit quality, make short dated investment-grade a good risk/return opportunity.

Market developments

August was a highly volatile month for fixed income and equity markets alike. At the beginning of the month, the US labour report sparked recessionary fears and prompted negative market sentiment. However, these concerns were quickly offset by strong economic data showing the US economy was still performing well. Although the data resulted in a sharp rebound in government bond yields and equity indices, the repercussions of the weak jobs report were present throughout the month as investors priced a more aggressive rate-cutting cycle by the US Federal Reserve (Fed) and other major central banks.

As with every month, the first Friday of August provided investors with the monthly US jobs report. However, in contrast to previous months, the labour market showed significant signs of weakening. The unemployment rate came in at 4.3% (higher than the expected reading of 4.1% and up from 3.7% at the beginning of the year), while non-farm payrolls printed at 114k, which was well below the anticipated 175k figure. In the immediate aftermath of the release, recessionary fears gripped markets, and economists began calling for meaningful action by the Fed in the form of rate cuts. Confidence of a soft landing diminished, which resulted in sharp negative moves across global equity markets, government bonds benefiting from a flight to quality, and growing expectations of a more aggressive rate-cutting cycle, with 10-year Treasuries having rallied to a yield of as low as 3.70%.

However, as the month unfolded, economic data pointed towards a US economy that was still performing well and, as a result, market sentiment began to improve. The supportive data included a very strong retail sales print, with the headline number accelerating to +1% month-on-month in July, significantly higher than the +0.4% expected and the fastest monthly retail sales increase since the beginning of 2023. The Fed also received positive news on the inflation front in August, with headline consumer price inflation undershooting expectations on a year-on-year basis, rising 2.9% (versus an expected 3%), which represents the slowest print since March 2021. Core inflation was in line with consensus at 3.2% at the year-on-year level. The revised estimates of second-quarter US GDP helped in painting an increasingly positive story for domestic economic growth. The headline GDP number was revised upwards to an annualised growth rate of 3% from 2.8% previously, and the Atlanta Fed increased its third-quarter GDPNow estimate to 2.5%. Nevertheless, Jerome Powell's speech at Jackson Hole at the end of August saw several dovish comments that all but confirmed the Fed will be cutting rates at its upcoming central bank meeting in September. Powell said "the time has come for policy to adjust" and acknowledged that "downside risks to employment have increased", suggesting the Fed is shifting its focus away from inflation and towards the employment side of the economy. Powell noted the recent uptick in the unemployment rate has been driven not just by weakening labour demand but very strong supply. He described the cooling in labour market conditions as "unmistakable", which resulted in markets increasing the probability that the Fed would execute a 50 basis point (bps) interest-rate cut in September to 33% by the end of the month.

In the UK, the Bank of England (BoE) delivered its first interest-rate cut in four years at the beginning of the month, with the 25 bps move made on a knife-edge 5-4 vote. Similarly to

the US, the UK had a soft inflation report. The headline number came in one-tenth below market expectations on both a monthly and annual basis, while core CPI also surprised on the downside, ticking down to 3.3% from 3.5% in the previous month. Services inflation fell noticeably from 5.7% in June to 5.2% in July, well below consensus expectations of 5.5%. UK unemployment also surprisingly fell to 4.2% in the second quarter, down from 4.4% in the first quarter, with the monthly reading of 3.6% for June representing the lowest reading since February 2022. Despite cutting rates at the beginning of August, the BoE struck a cautious tone at its last meeting and did not commit to further cuts in the near term, reiterating that it is now more focused on broader trends than individual data points.
In Europe, the preliminary headline CPI release for August was in line with expectations at 2.2%, as was core inflation at 2.8%. This figure represents the eurozone's lowest inflation figure for three years, opening up the opportunity for a second European Central Bank (ECB) rate cut in September, which the market is fully pricing in. There remain some doubts over the Eurozone's future economic growth prospects over the medium term. However, reassuringly, second-quarter GDP came in line with expectations at 0.6% year-on-year. Moreover, Purchasing Managers' Indices (PMI) posted a significant outperformance relative to expectations, with the composite PMI reading coming in at 51.2 (50.1 expected), supported by a strong reading from France amid the Olympics.

Portfolio review
The Fund retains a continued lower beta credit stance than normal given non-financial spreads, which, in the portfolio managers' (PM) views, are starting to look too tight for economic risks that remain significant. Likewise, spread duration remains lower than normal at 1.4 years, but interest-rate duration is now close to two years, with around 15% in our liquidity bucket of government bonds (US Treasuries and now bunds). Further, the PMs are concerned over Commercial Real Estate (CRE) issues in the US having the potential to create further insolvencies in the US regional banking sector. As a result, they have retained higher credit quality within both the banks and insurance sector by staying invested in more senior financials than is typical compared to the Fund's history. To be clear, the PMs have no credit quality concerns over the banks and insurers held in the portfolio given their Basel III regulated status, high capital ratios, high-quality loan books and healthy loan/deposit ratios. However, a further liquidity squeeze cannot be ruled out in an environment where depositors could be reading stories of failing US regional banks over the next few months. As such, the PMs believe it prudent to retain a lower level of risk in financials, keeping the overall beta of the Fund slightly lower than before.

Performance analysis
With a steady backdrop for rates and credit, despite some equity volatility during the month, the Fund delivered positive returns for the month.
Remarkably, and similar to last month, every bond in the portfolio was up in August, except for one: a five-year US Treasury bond that was added during the month. Therefore, all sectors were in the green again for a second month. Given a good month for risk assets, it was the higher beta sectors of Additional Tier 1s (AT1) and corporate hybrids that led the credit pack. Government bonds also had another strong month.

Outlook
With the European Central Bank having delivered the first rate cut for this cycle in June, and with the Bank of England following suit on 1 August, it is likely that the US Federal Reserve (Fed) will also cut in September after recent dovish commentary. As such, the major risks to capital from duration risk have ended. Therefore, the PMs have continued to become more tolerant of duration in the Fund, taking interest-rate duration up to 2.0 years, as noted earlier (please note this was described in detail in a recent webinar "The Duration Deliberation", which remains available on the website). However, on the flip side, the remaining yield curve inversion in rates curves and tight credit spreads in some sectors still give the PMs concerns about adding credit spread duration into the Fund right now, with the biggest capital gains likely to be in short dated bonds. As such, a modestly lower-than-average duration profile is still warranted, with peak yields still being less than two years to maturity – that is predominantly where the portfolio is focusing. However, as duration risks start receding, the PMs are concerned that increasing unemployment rates across the US, UK, and especially Germany signal worsening GDP data to come. Moreover, recession risks both remain significant and are not fully priced into non-financial spreads, in the PMs' views. Therefore, a lower beta credit stance remains warranted, although the prospect of further rate cuts suggests total returns from short dated credit can still remain attractive for some time yet.
In summary, we believe the combination of low duration and high average yield, with high average credit quality, make short dated investment-grade a good risk/return opportunity.

Fund characteristics

Fund name	Vontobel Fund – TwentyFour Absolute Return Credit Fund
ISIN	LU1267852082
Share class	I GBP
Reference index	–
Inception date	28.8.2015

Historical performance (net returns, in %)

Time period	Fund	Ref. index
MTD	0.5%	–
YTD	4.2%	–
1 yr	7.9%	–
3 yrs p.a.	1.3%	–
5 yrs p.a.	1.7%	–
10 yrs p.a.	–	–
ITD p.a.	2.4%	–

Time period	Fund	Ref. index
2023	5.9%	–
2022	-4.9%	–
2021	0.4%	–
2020	2.3%	–
2019	4.9%	–
2018	-1.0%	–
2017	5.1%	–
2016	4.9%	–
2015	–	–
2014	–	–

Past performance is not a reliable indicator of current or future performance. Performance data does not consider any commissions and costs charged when shares of the fund are issued and redeemed, if applicable. The return of the fund may go down as well as up due to changes in the rates of exchange between currencies.

Investment risks

- CoCo-Bonds are associated with significant risks, including the risk of coupon payments being cancelled, capital structure inversion risk, and the risk of a CoCo-Bond's maturity being extended.
- Asset-backed securities and their underlying receivables are often intransparent. The sub-fund may also be subject to a higher credit and/or prepayment risk.
- Using derivatives generally creates leverage and entails valuation risks and operational risks. Leverage magnifies gains but also losses. Over-the-counter derivatives involve corresponding counterparty risks.
- Securities with a lower credit quality means a higher risk that an issuer may fail to meet its obligations. The investment value may fall if an issuer's credit rating is downgraded.
- The sub-fund's investments may be subject to sustainability risks. The sustainability risks that the sub-fund may be subject to are likely to have an immaterial impact on the value of the sub-funds' investments in the medium to long term due to the mitigating nature of the sub-fund's ESG approach. The sub-funds' performance may be positively or negatively affected by its sustainability strategy. The ability to meet social or environmental objectives might be affected by incomplete or inaccurate data from third-party providers. Information on how environmental and social objectives are achieved and how sustainability risks are managed in this sub-fund may be obtained from vontobel.com/sfdr.

and the correct execution of the ESG strategy. As investors may have different views regarding what constitutes sustainable investing or a sustainable investment, the fund may invest in issuers that do not reflect the beliefs and values of any specific investor.

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