

Monthly commentary / 30.9.2024

## 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

- September was characterised by a material repricing in the market's expectations for the future path of interest rates, with investors pricing in a more aggressive rate-cutting cycle by major central banks. Encouraging data out of the US supported the soft-landing narrative, while economic growth in large parts of the Eurozone continued to weaken.
- With the 50bp cut from the Fed, and further economic weakness in Europe, rates positions in the Fund did particularly well, with the Fund generating a positive return over the month.
- With the ECB having now delivered its second interest-rate cut, and the Fed cutting rates by 50bps in its first rate cut this cycle, the prospects for repeated cuts now look excellent through 2024 and 2025. As such, the major risks to capital from duration risk have ended; the PMs have continued to become more tolerant of duration in the Fund, taking interest-rate duration up to 2.0 years. In summary, we believe the combination of low duration and high average yield, with high average credit quality, still make short-dated IG a fantastic risk/return opportunity.

### Market developments

September was characterised by a material repricing in the market's expectations for the future path of interest rates, with investors pricing in a more aggressive rate-cutting cycle by major central banks. This led to a bull steepening of yield curves and helped drive strong returns across a host of sectors within fixed income. Encouraging data out of the US supported the soft-landing narrative, while economic growth in large parts of the Eurozone continued to weaken.

Given the weaker-than-anticipated labour data out of the US in August, the US jobs report at the beginning of September was a key date in investors' diaries last month. The highly anticipated report provided something for everyone. The unemployment rate ticked down to 4.2% from 4.3% previously (as expected), but non-farm payrolls (NFP) only rebounded to +142k, below the forecasted +165k figure. This came alongside downward revisions to NFP numbers for both July and June, which drove the narrative that the US labour market is still seeing tangible signs of weakening. Volatile moves followed the report on the rates side, with the 10-year Treasury yield dropping by almost 20 basis points (bps) over the week to 3.71%, representing the lowest closing level since June 2023. The 2s10s curve rose into positive territory following the report, marking the end of the latest period of Treasury curve inversion that dated back to July 2022. US headline consumer price inflation (CPI) later in the month came in at 0.19%, taking the year-on-year figure down to 2.5%, which was in line with expectations but represented the lowest annual rate since February 2021. However, there was an upside surprise for core inflation, which printed at +0.28% on a month-on-month basis, primarily driven by an uptick in owner equivalent rent, which came in at a seven-month high of +0.5% for August alone. Despite the labour market and inflation reports

coming broadly in line with expectations, reports from well-sourced journalists suggesting a 50bp interest-rate cut was on the table for the US Federal Reserve (Fed)'s September meeting fuelled a growing and subsequently dominant narrative that the Fed would indeed deliver a half-point cut. The Federal Open Market Committee (FOMC) eventually did announce a 50bp interest-rate cut, marking the beginning of the cutting cycle for the US central bank as it lowered the Fed funds rate to 5%. The decision was split 11-1, with member Michelle Bowman becoming the first Fed governor to dissent since 2005, opting for a 25bp cut instead. The FOMC also revealed downward revisions to inflation projections, with 2025 personal consumption expenditures (PCE) lowered by 0.2% to 2.1%, and upward revisions to the unemployment rate forecast to 4.4% from 4.2% previously. Updated dot plot projections showed that the median FOMC member expects the Fed to cut by a further 50bps to 4.5% by year-end and 3.5% by the end of 2025, which was more hawkish than what the market was perhaps expecting. US economic data in the days following pointed towards the US economy remaining resilient and inflationary pressures being kept under control. Retail sales were stronger than anticipated at +0.1% versus -0.2% expected and headline PCE inflation printed marginally below expectations at +2.2% on a year-on-year basis versus the expected +2.3% figure (the lowest reading since February 2021). In line with Fed commentary throughout September, the data served as further evidence that inflation is being tamed, although the battle is not yet completely won. In Europe, the European Central Bank (ECB) delivered a 25bp rate cut, in line with market expectations, reducing its deposit rate to 3.5%. Updated forecasts showed marginally downgraded growth projections to +0.8% for year-end 2024,

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+1.3% for 2025 and +1.5% for 2026. Headline inflation forecasts were kept unchanged, but core CPI forecasts were raised. Purchasing Managers' Indices (PMI) towards month-end were very weak, with signs of significant economic weakness across large parts of the Eurozone. The Eurozone's composite PMI figure printed at 48.9 in September, down from 51.0 in August and materially underperforming the 50.5 expectation, driven by a continued decline in manufacturing activity across the bloc. The print led some investment banks to downwardly revise their GDP forecasts for the Eurozone for the remainder of the year. Markets began pricing in another quarter-point rate cut by the ECB in its October meeting as weak economic data emerged.

The Bank of England (BoE) bucked the trend and kept its policy rate unchanged at 5% last month, with members voting 8-1 in favour of holding rates, broadly in line with market forecasts. The announcement followed UK headline CPI coming in line with expectations at +2.2%. However, core inflation ticked up to 3.6% on a year-on-year basis, with the move largely driven by an increase in services inflation to 5.6% from 5.2% previously. In light of this, Governor Andrew Bailey stated that BoE members "need to be careful not to cut too fast or by too much" as core inflation is still running significantly higher than the bank's 2% target. Economic activity is not yet showing signs of material weakening in the UK; strong PMIs suggest net economic expansion as the composite figure printed at 52.9 and retail sales outperformed economist forecasts at +1% month-on-month. On the labour side, the unemployment rate fell by one-tenth to 4.1% in September, as did average weekly earnings to 4.0% on a year-on-year basis.

#### Portfolio review

The Fund retains a continued lower beta credit stance than normal given non-financial spreads which, in the PMs' views, are starting to look too tight for economic risks that still remain significant – and even deepening. 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 issues in the US having the potential to create further insolvencies in the US regional banking sector. Thus, 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 keep a lower level of risk in financials, keeping the overall beta of the Fund slightly lower than before.

#### Performance analysis

With the Fed's 50bp cut and further economic weakness in Europe, rates positions in the Fund did particularly well, with the Fund generating positive returns for the month.

Government bonds led returns, with both the five-year positions in US Treasuries and German bunds doing well. Bunds outperformed slightly given poor economic data in Germany. Financials contributed positively to the Fund's total return, with the insurance sector edging banks. However, in both cases, subordinated subsectors led returns over senior. The asset-backed security (ABS) sector returned just below the portfolio average.

#### Outlook

With the ECB having now delivered its second interest-rate cut, and the Fed cutting rates by 50bps in its first rate cut this cycle, the prospects for repeated cuts now look excellent through 2024 and 2025. As such, the major risks to capital from duration risk have ended; the PMs have continued to become more tolerant of duration in the Fund, taking interest-rate duration up to 2.0 years, as mentioned 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 cause the PMs concern 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 remains warranted, with peak yields still being less than 2 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 remain attractive for some considerable time yet.

In summary, we believe the combination of low duration and high average yield, with high average credit quality, still make short-dated IG a fantastic risk/return opportunity.

**Fund characteristics**

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

**Historical performance (net returns, in %)**

Time period	Fund	Ref. index	Time period	Fund	Ref. index
MTD	0.7%	–	2023	5.9%	–
YTD	4.8%	–	2022	-4.9%	–
1 year	8.0%	–	2021	0.4%	–
3 yrs p.a.	1.6%	–	2020	2.3%	–
5 yrs p.a.	1.8%	–	2019	4.9%	–
10 yrs p.a.	–	–	2018	-1.0%	–
ITD p.a.	2.5%	–	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](http://vontobel.com/sfdr).

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