Monthly commentary / 30.06.2020
Vontobel Asset Management

Vontobel Fund - EUR Corporate Bond Mid Yield

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

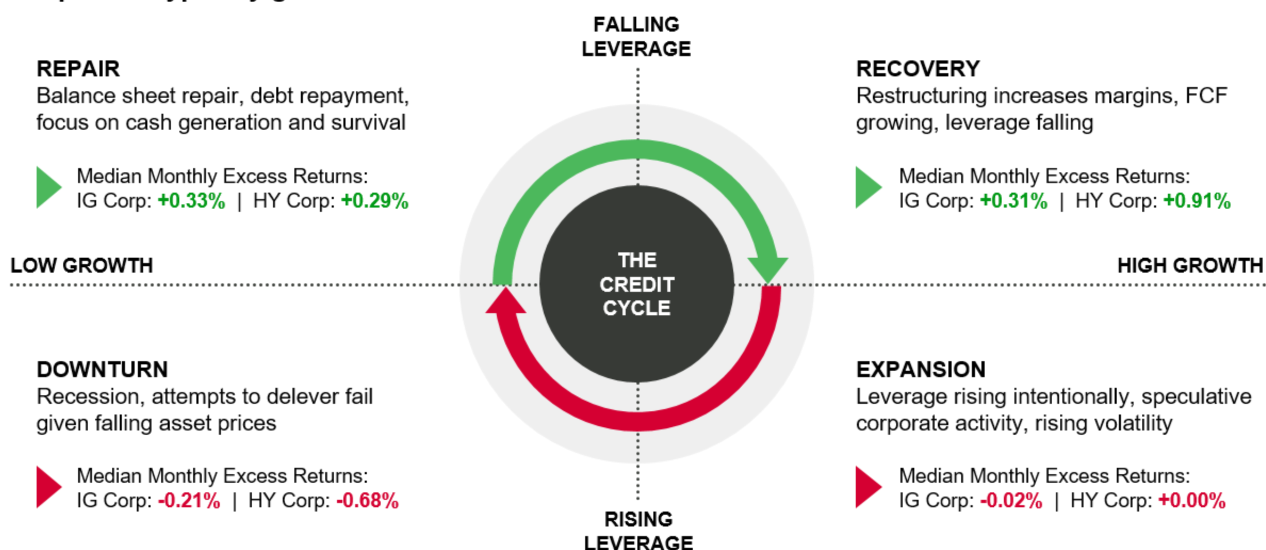
Market developments

Summer is upon us and we believe this season should continue to be risk on! In the last week or so, doubts may have developed as investors have closely focused on new virus hotspots in the US, China, and Latin America, which have popped up and were frenziedly reported on. There have been questions about the resurgence of the virus and a second wave that could eventually disrupt our markets recovery, especially as they have experienced a very good run of late. We remain confident, however, and we will highlight our rationale and thoughts below that the positive trend should continue undisturbed. But prior to this, June was another very good month for the European Area investment-grade credit market making the second quarter extremely good too. Indeed, during June, spreads tightened from 17 to 35 basis points on average. The best performing segments were senior cyclical and periphery corporates – metals and mining, capital goods, aerospace, building materials to name some – whilst subordinated instruments slightly lagged, except for periphery subordinated bonds. The periphery theme continued to be well supported given the European Recovery Fund announcement with periphery government yields narrowing and out-performing the Bund during the period.

But first with the resurgence. We do anticipate clusters to emerge but they should stay well localized. We can avoid a second wave if governments aggressively contain the virus through testing, tracing, and isolating carriers. Encouraging good hygiene is also a good defense, such as hand washing, encouraging the wearing of masks, supporting social distancing, and environmental disinfecting. This is how the hotspots are being handled in Europe and Asia at this stage and it is encouraging to see that certain US states are also starting to embrace such practices. We think of the hotspots as small fires that can be extinguished, and we do not expect major lockdowns to re-appear again this year. They would rather be localized and well targeted by health authorities minimizing any economic impact. Whilst there may be temporary loss of momentum in certain areas, there should be continued economic improvements in other areas still lifting the economic aggregates. We therefore continue to see global economic activity continuing to improve, supported by selective government health responses keeping us in the V or more precisely the "Swoosh" recovery camp, and this until a vaccine is broadly available by the end of the year. We have previously reported that there is now a higher probability of at least some effective therapeutics to be available by the end of 2020. Such therapy should be available for hospital treatment use by the end of the year first, with a vaccine likely to be available to the wider population by spring 2021. The Astra-Zeneca Oxford joint venture remains quite promising and this would represent a welcome development that would surely help sustain higher retail and economic activity.

As clusters emerge, and as economies bottom, the latter should still receive both fiscal and monetary policy support with good coordination amongst policy makers providing effective bridges until therapy is widely available. In the US, for instance, it is expected that US policy makers agree to an additional one trillion US dollars in fiscal stimulus before the August recess, especially given the recent developments relating to Covid-19 there and the continued high number of weekly unemployment claims. The need for extending unemployment benefits has become more evident in the last couple of weeks. As for the US Federal Reserve, and as investor have started reflecting on potentially doubting the recovery following a rise in new cases, Chairman Powell has reinforced that the benefit from the easier policies will become evident over time to dispel any of these doubts. Their interventions will keep rates at the effective lower bound and to support this notion the Fed Chairman stated that they were "not thinking about thinking about raising rates". They are thinking that the economy needs support from monetary policy for an extended period of time, and not just through interest rates, but also through asset purchases. Their aim is to go back to last February's 3.5% unemployment rate, and we have just started repairing the system (see below regarding the shifting drivers of the credit market cycle). In Europe, and equally, the European Central Bank and policy makers are targeting market recovery and stability. Philip Lane, member of the Governing Council, recently declared that the increase in the Pandemic Emergency Purchasing Programme was being guided by improving monetary conditions and stabilizing financial markets with its exact figure being of secondary importance. Furthermore, the European Recovery Fund is now tantamount to early debt mutualisation steps with significant benefits for Southern or periphery economies as it will help avoid leaving a permanent scar on these economies. We see the proposed Recovery Fund as a continued catalyst for spread tightening, especially positive for periphery corporates and financial institutions.

Given that investors' doubts could be increasing, we would now turn to the shifting drivers of market cycles, as such investor doubts typically correspond to an early stage recovery phase of a market cycle or repair stage. We have stated earlier that we do not expect broad or major lockdowns to be re-introduced. We can also rely on good coordination from policy makers to help us move from bottom to an early recovery stage. Presently, and after reaching bottom, corporates are doing their part to stay alive rather than grow. The primary focus of hoarding liquidity and building cash levels is also giving way to debt repayments and balance sheet repair. The V or Swoosh shape recovery will transition us slowly but surely into a mid-stage bull market or recovery stage by year-end that should be supportive of riskier assets. As output rebounds, it is worth noting that consumption recovers much quicker than one thinks and a good precedent for this is the last Great Financial Crisis when consumption had already recovered to pre-recession levels by the third quarter of 2010. Today, we would argue that household balance sheets are in much better shape going into this recession. All this is providing a solid springboard for the recovery to gain momentum, with the repair stage we have entered bodying very well for developed market corporate bond spreads still.



Portfolio review

Sentiment in the European credit market is much better than in March/April and cyclicals as well as peripheral names performed very well in June. We expect this to continue and, therefore, did not change the basic structure of the fund but kept our key performance drivers in place. On a sector level, we have increased our capital goods exposure by 1% compared to the previous month and our real estate exposure by close to 0.5%. We invested inflows in senior paper of fundamentally solid names that offer an attractive spread pickup, for example, Klepierre, Holcim, and Heathrow. In the primary market, we participated, among others, in MTU Aero Engines – a well-known and fundamentally solid name in a currently challenged industry, that we believe will remain investment-grade rated and where the new issue spread of ms+346bps more than compensates for the risk taken. Over the summer and for the rest of 2020, euro investment-grade corporate industrial issuance could also slow down as corporates will not need to fund much more and as blackout periods start. In addition, if the ECB keeps buying corporates at the current pace of about 20 billion euros per month – the net supply of industrial corporates should be approximately 170 billion in 2020 – 50 billion less than in 2019 according to BNP research. This theme of 'bonds scarcity' should also provide a very strong technical support for corporate bond spreads.

Performance Analysis

The Vontobel Fund - Euro Corporate Bond Mid Yield (I share class) outperformed the reference index over the month of June, however, the fund did experience a larger outflow that affected performance on the last day of the quarter. Sector allocation wise, main performance contributors were insurance and banking, with the sovereign bond exposure (cash equivalent) and ITRX Sen Fin CDS exposure also performing well. On aggregate, the relative underweight in retail, basic industry and consumer goods detracted from performance as they recovered strongly in June. As highlighted in the portfolio review part, we did selectively increase our exposure to these sectors.

From a selection perspective, bank names including periphery subordinated structures performed very well (e.g. Banco de Sabadell subordinated, Mediobanca senior), real estate names were strong contributors (e.g. Hammerson and Prologis) as well as telecom names (e.g. Telecom Italia and Cellnex). Some energy names contributed slightly negatively (e.g. Total hybrids).

Outlook

We believe that any recession we experience should be temporary and short-lived, and we would not be surprised if 2021 sees solid economic growth in the mid-single digits. Such backdrop together with the shifting cycle drivers should sustain further spread tightening.

European credit spreads should hence represent the base for good yield and carry income for some time to come. We see performance catalysts in BBBs and BBs, peripheral national champions, cyclical sectors, real estate, telecom, and banking/insurance – senior as well as subordinated structures.

Investors should get a better sense of what is to come as they see the stabilization to the Covid-19 situation confirmed with the re-opening of many economies for both working and retail activities. The tremendous liquidity from all central bank actions that will stay in the markets for some time – even after recovering – also speaks for a solid reversal in spread levels from a technical perspective. We saw the ECB increasing and enhancing its Pandemic Purchase Programme, which should see the net supply of industrial corporates bonds available to regular investors decline in 2020. The fact that corporates have already boosted their liquidity coffers also means that we should increasingly experience corporate bond scarcity during the second half of the year.

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Performance (in %)

Net returns			Rolling 12-month net returns			
EUR	Fund	Index	Start date	End date	Fund	Index
MTD	1.2	1.4	01.07.2019	30.06.2020	-0.1	-0.5
YTD	-2.0	-1.4	01.07.2018	28.06.2019	5.5	4.9
2019	8.8	6.6	01.07.2017	29.06.2018	0.2	1.1
3 years p.a.	1.8	1.8	01.07.2016	30.06.2017	3.4	1.6
5 years p.a.	2.6	2.4	01.07.2015	30.06.2016	4.0	5.1
10 years p.a.	4.8	3.7	Index: ICE BofAML A-BBB Euro Corporate Index			
Since launch p.a.	4.1	3.9				
Launch Date		13.07.2007	Share class: I ISIN: LU0278087860			

Past performance is not a reliable indicator of current or future performance. Performance data does not take into account 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.

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Vontobel Asset Management AG
Gotthardstrasse 43, 8022 Zürich
Switzerland
T +41 58 283 71 11, info@vontobel.com

vontobel.com/am