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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

We are in the midst of summer-vacation season and believe it should continue to be risk on. July may have brought a pivotal change to the future of Europe when the EU leaders finally found a mutual agreement to support the struggling member states with a 750 billion euro (around 5% of EU-27 GDP) financial package. This news is pivotal in a sense that all member states found a common ground and this will undoubtedly influence the cooperation in the future and strengthen Europe as a constitution. In addition, this is the long awaited fiscal support alongside monetary policy measures to help the member states weather the storm. The overall size of the package is generous and of macro economically relevant size for the most severely impacted countries. The 750 billion euros are composed of 390 billion in grants and 360 billion in loans and were negotiated in parallel to the seven-year 1.8 trillion euro budget. Disbursement should start in 2021, once ratified by the European and national parliaments, with 70% of the grants front-loaded. This is supportive for markets in general and for the periphery more specifically, given lower risk premia across the region and large expected boost to GDP. For the first time since the Covid-19 related sell-off in markets, 10-year Italian government bond yields have fallen below 1%.

The US Federal Reserve announced at its last meeting that all lending facilities currently active, will be extended by three months until the end of the year and Chairman Powell reinforced the importance of the evolution of the virus for the economic outlook and highlighted the need for further fiscal and monetary support. As per time of writing, negotiations between Democrats and Republicans to restore the 600 US dollars per week jobless benefit that expires end of July are still ongoing. Our base case is that they find an agreement at some stage, especially as we are in an election year, in order to continue supporting the consumer.

Credit spreads continued to tighten in July and the Euro Corporate Bond A-BBB reference index has tightened by 22 basis points to a level of 135 Govt OAS. The move in the BB index was even more pronounced and the respective index tightened by 39 bps to a level of 358 Govt OAS. Is there room left for further spread tightening? We believe there is room left to tighten to pre-Covid levels (around 50 bps for investment grade and around 150 bps for high yield). Fundamental data is improving, supply in the second half of the year is expected to be net negative 150 billion euros for EU investment grade according to BNP research and quantitative easing (QE) is in full purchase mode, which should provide further technical support ('bond scarcity').

We are halfway through the earnings season and more than 50% of both Stoxx 600 and S&P 500 have reported. In general, Q2 earnings have been better than expected and companies did take mitigating measures (e.g. dividend cuts, capex cuts, and asset sales) to soften the financial hit from Covid-19. These numbers look good, but expectations for Q2 had already been very low and assessment of the precise Covid-impact is difficult. We think Q3 results and revised outlooks will be key to watch and should provide a clearer picture of the fundamental health of corporates once the dust has settled.

Covid-19 cases have risen around the globe, while in many countries the rate of mortality and hospitalizations is lower. 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, we hope, 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 end 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.

Q2 euro area GDP data was better than expected for most regions. Following a sharp contraction in March and April, the euro area has recovered robustly in May and June on the back of initial lifting of restrictions. We believe that economies in the euro area and in the US have seen the bottom and should rebound from here.

Portfolio review
Sentiment in the European credit market is much better than in March/April and we expect this to continue and, therefore, did not change the basic structure of the fund, but kept our key performance drivers in place. Our overweight in the periphery benefited strongly from the EU recovery fund development and we believe this will be supportive for the periphery going forward.
In the primary market, we participated in Generali Subordinated, Leonardo, and Fiat Chrysler senior issuance and in the secondary market we topped-up our exposure in MTU Aero Engine and added Legal & General Sub in US dollars that offer a spread pickup compared to British pound sterling ones and we have sold our exposure in Miller Homes.

Performance analysis
The Vontobel Fund - Euro Corporate Bond Mid Yield (I share class) outperformed the reference index over the month of July. Credit spreads continued to tighten for the fourth consecutive month and new issue activity slowed down markedly providing technical support. Sector wise, main performance contributors were insurance and transportation. Our government bond exposure (cash equivalent) also contributed positively on the back of the relatively large rates moves (e.g. 10-year BTP yield tightened more than 20 bps). The relative underweight in consumer goods, healthcare, and automotive contributed slightly negatively.
From a selection perspective, subordinated bank and insurance bonds (e.g. Intesa Vita, Sabadell, Bankia, and Unicredit) supported performance strongly, boosted by the positive sentiment on the back of the EU recovery fund headlines. In general, more cyclical names like Glencore, Fiat Chrysler, or airline-linked ones like Avolon had a strong run in July. The Atlantia-complex (e.g. Autostrade, Abertis, and Aeroporti di Roma) performed well in July as a long-awaited agreement was reached with Italian state lender CDP about to take a majority stake in Autostrade through a capital increase. Corporate Hybrids selectively lagged the reference index performance in July (e.g. Unibail, Total, and Repsol).

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 a 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.
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 European Central Bank increasing and enhancing its pandemic purchase program, 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.
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 more quickly than some think 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 boding well for developed market corporate bond spreads still.
Furthermore, the European Recovery Fund is now tantamount to early debt mutualization steps with significant benefits for Southern or Periphery economies as it will help avoid leaving a permanent scar on these economies. We see the Recovery Fund as a continued catalyst for spread tightening, especially positive for periphery corporates and financial institutions.

Performance (in %)

Net returns			Rolling 12-month net returns			
EUR	Fund	Index	Start date	End date	Fund	Index
MTD	2.2	1.6	01.08.2019	31.07.2020	0.8	-0.4
YTD	0.2	0.1	01.08.2018	31.07.2019	6.5	6.1
2019	8.8	6.6	01.08.2017	31.07.2018	-0.3	0.7
3 years p.a.	2.3	2.1	01.08.2016	31.07.2017	2.3	0.6
5 years p.a.	2.8	2.5	01.08.2015	29.07.2016	4.6	5.6
10 years p.a.	4.8	3.8	Index: ICE BofAML A-BBB Euro Corporate Index			
Since launch p.a.	4.3	4.0				
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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