Monthly commentary / 31.08.2020
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
Welcome back from summer, when the summer was much better than expected in terms of spread tightening and when Q2 earnings were generally better than anticipated too. Companies did take measures (e.g. dividends cuts, capex cuts, and asset sales) to soften the impact from Covid-19, and the better earnings results were coincident with more positive revisions in one-year forward earnings expectations making the outlook brighter. Indeed, over the summer, four-week rolling EPS (earnings per share) positive revisions, as a percentage of total revisions, continued to improve to above 50 in the European Area (EA) and 70 in the US indicating that there are more EPS upgrades than downgrades. This is what is to be expected from improving drivers of market cycles as we transition to a mid-stage bull market or recovery stage by the end of the year. But returning to credit spreads in our market, whilst we would have expected them to remain range bound in August, they actually continued to perform strongly. Senior industrial bonds narrowed 12 to 15 basis points on average whilst subordinated instruments and BBs tightened by up to 30 to 35 bps. Sector wise the outperformers were cyclicals and transportation, with sub financials also performing well. Over the summer, periphery credits were well supported outperforming core Europe.

It is then no coincidence that the positive spread and earnings performance mentioned above is in line with the notion of shifting cycle drivers introduced at the beginning of the summer. We are transitioning through the credit cycle faster than anticipated and the magnitude of the recovery will likely gain speed to exceed expectations. In the EA, the news of the European Recovery Fund as reported previously is 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. In the US, we now have no doubt that the recovery cycle will gain further traction by the end of 2020 after the US Federal Reserve and Chairman Powell released early, at their Jackson Hole Symposium, their revised statement on their “Longer Run Goals and Monetary Policy Strategy”. The “swoosh” shaped recovery should hence transition us into a mid-stage bull market or recovery stage that should continue to be supportive of credit spreads at least until the year-end. The key drivers being both fiscal and monetary support even as economies recover, and vaccine research developments that would create upside potential to Covid-19. The excess liquidity in the system is to continue to trump global risks, including the US election risks, which for us would only induce a bit of short-term volatility and not threaten the recovery.

Of keynote during the month of August, was the speech by Mr. Powell at their annual Jackson Hole Symposium that was held in a virtual mode this year. The opening remarks are of key importance as it establishes the direction of the Fed’s monetary policy for at least 12 months and beyond. Chairman Powell delivered revisions to the Longer Run Goals that were extremely dovish and likely to support the recovery.

This year’s Symposium is now confirming that the Fed is worried by the lack of inflation and our labelling of Era 3 as the “Miss-ingflation Era” is all the more appropriate today (you will recall last year’s Symposium when Mr. Powell introduced the 3 Eras of Monetary Policy with the third Era starting in 2010 that remained without a label). Indeed, at this years’ Symposium, the Fed announced that it is pivoting its inflation strategy from a 2% forward looking symmetric inflation target, to targeting 2% inflation on average “over time”. They think that this will better articulate their inflation goal and will support better economic growth and job creation. Their pursuit of average inflation at 2% means that the Fed plans to keep interest rates at zero until inflation reaches on average 2%, and is sustained at that level for quite some years. Looking back at the past, their projections for Personal Consumption Expenditures Inflation had been below 2% in a persistent manner since 2012, and one can imagine that the Fed will refrain from raising interest rates for quite some time even if inflation overshoots above 2% for some years. By our count there may not be any interest rate hikes keeping rates at the Effective Lower Bound (ELB or zero) in the US until 2024. This assumes that the recovery plateaus sometime in 2022 with the Fed allowing inflation to overshoot above 2% for a couple of years to ensure that it is sustainable. Their notion of average inflation over time would allow for that, especially as their inflation projections experienced periods of persistent undershoot since 2012. Along such rates and inflation policy, the Symposium opened the door to an Enhanced Quantitative Purchasing Programme that could include an extension of the duration of purchases that will definitely be supportive of the recovery and spreads on a sustained basis. This could be announced as early as the September FOMC meeting.

On the upside potential to Covid-19, there are many last phase trials and the number of deaths and intensive-care admissions have not risen materially suggesting that current distancing and protection measures are efficient. We have most likely reached an inflection point to Covid-19 with a higher probability today that some effective therapy will become available by end 2020. Such therapy should be available for hospital treatment use first, with a vaccine widely available for the population in 2021. The Astra-Zeneca/Oxford joint venture is the most promising one, and would deliver further upside potential to both the US and EA economic and credit cycles.

Portfolio review

We expect to see low rates for an extended period especially as the Fed now transitions from Stabilisation to Accommodation following Jackson Hole. Thus, we have increased our exposure in longer dated bonds in euro and US dollar (currency hedged). Names we have added include BP, VOD, and KKR for example. The hunt for yield still makes corporate hybrids attractive and we participated in the new Vodafone issuance in August.

We will continue to moderately increase our position in longer dated corporate bonds in the coming months and see this strategy as one of the key performance drivers for the second half of 2020 and 2021. In general, spread products should remain well supported on the back of central bank accommodation, sustained hunt for yield and expectation for net negative new issuance in euro-denominated corporate bonds (‘bond scarcity’).

Our sector preferences remain valid and we see value in real estate, banking, financial services, insurance (subordinated), and telecom (hybrids) and remain overweight on a risk-adjusted basis. Our BB exposure is stable around 16% that should be very supportive. On average, the BB rated senior bucket trades at an OAS spread of 325 bps while our ICE BofA EUR A-BBB reference index trades at an OAS spread of 120 bps and we see selective BB as a valuable addition to our fund.

Performance analysis

The Vontobel Fund - Euro Corporate Bond Mid Yield (I share class) outperformed the reference index over the month of August. Credit spreads continued to tighten for the fifth consecutive month and new issue activity only picked up towards end of August.

Sector wise, main performance contributors were insurance, transportation, and energy. Government curves steepened towards the latter part of August, however in aggregate, our government bond exposure (cash equivalent) contributed positively to performance. The relative underweight in healthcare, consumer goods and basic industry contributed negatively.

Selection-wise, our exposure in subordinated financials (e.g. Belfius AT1, Intesa AT1, and Legal & General Sub) was a strong performance driver as well as the recent MTU Aero new issuance, short-dated Hammerson bonds and Avolon senior bonds that continued to tighten. These were all heavily hit sectors during the sell-off. Telecom Italia – a name we have liked for some time – also performed well on the back of headlines around the creation of a single national network in Italy.

Outlook

Spreads have continued to tighten throughout summer and with central banks around the world continuing to buy, the technical bid is very strong and comes on the back of decent earnings data. We expect these drivers for credit spreads to remain in place for some time and feel confident, that our view has just been confirmed by Jerôme Powell at the last Jackson Hole meeting. Any recession experienced 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 – where some spread pickup is available.

The tremendous liquidity from all central bank actions will stay in the markets for some time. We believe that corporate bonds will become the next ‘government bonds’ where investors see value on the back of acceptable risk. There are opportunities around, especially after the recent sell-off and in those sectors where spreads have not recovered to pre-crisis levels yet and where we expect them to do so over time. Some hard hit sectors like aviation, real estate, and retail now offer selective opportunities with attractive spread pickup. Besides single-name strategies, we believe in the performance-potential for longer dated bonds and our usual key performance drivers in the form of subordinated structures.

Performance (in %)

Net returns			Rolling 12-month net returns			
EUR	Fund	Index	Start date	End date	Fund	Index
MTD	0.5	0.2	01.09.2019	31.08.2020	0.2	-0.9
YTD	0.6	0.3	01.09.2018	30.08.2019	8.0	6.8
2019	8.8	6.6	01.09.2017	31.08.2018	-0.9	0.1
3 years p.a.	2.3	2.0	01.09.2016	31.08.2017	2.0	0.8
5 years p.a.	3.0	2.7	01.09.2015	31.08.2016	6.2	6.8
10 years p.a.	4.7	3.6	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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