TwentyFour
a boutique of Vontobel

Fund Commentary | 31 May 2024

TwentyFour Sustainable Enhanced Income ABS Fund

This Commentary is a marketing communication for professional UK investors only

Market Commentary

If April was a difficult month for markets, May proved to be almost the exact opposite, with rates rallying, credit spreads tightening and US equity markets recovering from the April dip and hitting new highs.

Starting in the US, strong economic data and persistent inflation had pushed 10-year Treasury yields to year-to-date highs of over 4.7% in late April. At the start of May, the Job Openings and Labor Turnover Survey (JOLTS) data came in much weaker than predicted, while the ISM Manufacturing New Orders index also fell to contraction territory, giving some respite to the markets. Later that evening, the Federal Reserve (Fed) kept rates on hold and, although Chairman Powell was not dovish in his comments, the pace of quantitative tightening (QT) was slowed by more than expected. With the statement being less hawkish than markets feared, and QT slowing significantly, markets enjoyed a relief rally. This gained traction later in the week, when non-farm payroll data fell to 175k, much lower than the 240k expected, while the unemployment rate rose slightly to 3.9%, and average hourly earnings also fell, to 0.2% for the month and 3.9% year-over-year (YoY). This data supported arguments that the labour market was finally loosening and wage inflation was slowly normalising – important factors if the Fed is to cut rates later this year.

Economic data in the eurozone was mixed but with signs of economic activity picking up and growth returning. However, a rate cut from the European Central Bank (ECB) has been fully priced in for June, and there was considerable debate as to how far the ECB would be willing to diverge from the US should the Fed continue to hold firm on rates. Rate cut expectations for the ECB were maintained at between two and three by year-end. In the UK, inflation came in hotter than expected but continued to fall; headline UK inflation at 2.3%, below both the US and eurozone, which would have been seen as unlikely a year ago. However, with GDP growth coming in better than expected, the outlook for rate cuts is also mixed, and just over one cut is expected this year.

Away from macro data, the political scene hotted up, with a general election being announced in the UK for July 4, with the Labour party well ahead in the polls, although both the Labour and Conservative parties are perceived as being fairly centralist, and little economic impact is expected. The Bank of England (BoE) announced that it would cease communications until after the election (although it remains unclear whether anyone noticed!).

Summary

The European ABS markets performed well during May. Spreads continued to compress, particularly at the shorter end, and the iTraxx Crossover Index ended the month back under 300. The support of the macroeconomic environment has also meant collateral deal performance has remained healthy, and deterioration has remained limited to risk pockets such as pre-Global Financial Crisis (GFC) mortgage collateral and commercial mortgage-backed securities (CMBS) backed by office assets. Primary issuance year-to-date (YTD) sits at a €69bn, an 83% increase on 2023 levels. During May, we saw €19bn of ABS and €5bn of CLO new issue, with a series of mid-year updates now seeing the market entering a new phase of health and growth.

RMBS

RMBS markets remained active through May, with prints out of the UK, Ireland, and the Netherlands. Cumulative issuance now sits at €29.6bn for 2024. In the UK, we saw a mix of bank prime (including a re-entry of TSB Bank to the RMBS markets) and debut specialist lenders. UK bank prime spreads were firm during May, with 5-year paper printing at 55bps over SONIA and books 1.4X covered. The non-conforming (NC) and buy-to-let (BTL) space saw multiple established issuers come to market, including Keystone, Lendco and Shawbrook as they continue to take advantage of favorable funding costs. AAAs for these issuers have ended in the 85-88bps region, with coverage well over 1.5X. Strong coverage remains the case for the mezzanine tranches, with BBBs finding a new level around 220bps over SONIA. Towards the end of the month, we saw a full cap stack print from debut retirement lender LiveMore. The premium for a new lender and asset type was not present, in our view, with AAA pricing at 88bps, in line with BTL, however, investors did demand a 50bps premium for the BBB tranche that priced at a spread of 280bps. Away from the UK, we saw a transaction from seasoned Dutch BTL issuer Domivest. May also saw a successful issue from Barclays Italian mortgage book, where over €3bn of paper was issued. Final levels for the AAAs were 68bps from guidance of low 70bps, and BBBs ended at Euribor +200bps, edging closer to 2021 tights. As flows continue into the markets, the healthy supply is easily absorbed, but we have seen signs of tiering returning for new issuers in the sub-investment grade (IG) tranches.

CLO

The pace of CLO issuance continued during May, with 20 CLO issuances, including refinancing, and putting YTD issuance at €21.9bn for new issue and €6.9bn for refinancing. AAAs spreads in primary ended the month 2bps tighter, at 146bps, which continues to look attractive on a historical basis and in comparison to AAA corporate indices. The dispersion between managers further down the stack continues, with BBBs in ranges of 330-450bps and BBs between 620 and 740bps. There have been updated spread expectations from banks at the AAA level, but a lack of loan supply could counter managers' ability to ramp the portfolios. The euro leveraged loan index rallied over a point during May, to 98.1.

Other ABS

We had an active month in ABS markets, seeing prints in UK cards, Italian consumer, UK RMBS and Autos from multiple jurisdictions. We saw two CMBS deals during May, a positive sign of lending activity and a sign of resurgence for the sector in H2 as we had foreseen, resulting in more trading activity across shelves. The first was a UK logistics deal from Blackstone, with the AAAs pricing at 165bps, from guidance of mid-high 100bps, and was 2X covered. The second was a data centre deal from Vantage, a fixed rate tranche with a coupon of 225bps over the equivalent UK Treasury, which ended 2X covered. Although demand was plentiful in both transactions, there is a note to be made here on an avoidance of office and retail collateral, given noise in the sector. In the consumer space, we saw further issuance out of Italy, with a deal from Alba where AA seniors priced at 82bps over Euribor. Also in the consumer space, we saw a successful deal from debut Dutch issuer Lender and Spender. Coverage on the Lender and Spender deal was particularly strong for a first-time issuer, with AAAs tightening 6bps to a spread of 69bps, and ended 3X covered along with mezzanine subscription of 5-6X on the IG tranches, although sub-IG did fall behind at 1.5X coverage.

Secondary Markets

May was a busy month for secondary markets, particularly in ABS markets. CLO secondary supply moved away from AAA dominance during May, as investors looked at mezzanine rotations. The bulk of the spread tightening for May was in the sub-IG tranches of CLOs, with BB and Bs 20bps tighter on the month.

ABS secondary markets saw close to €1bn of paper on BWIC for May, with 75% coming from the UK ABS space. As investors look to new issue rotations in the ABS space, the paper remains well absorbed despite very active primary markets, and we have seen strong BWIC covers during the month, with UK seniors clearing in spreads of 70-80 over SONIA, and particularly strong prints from shorter euro consumer deals in the high 50bps.

Portfolio Commentary

May was a relatively busy month for the Fund. The team continued to allocate to primary CLOs, where BBs at Euribor + 6.7% continued to look cheap on a historical basis and in comparison with corporate bonds. During May, the portfolio management team reduced exposure to pre-GFC RMBS pools, where the call upside was limited. These proceeds were deployed into mezzanine consumer deals at a spread over Euribor of 5.5%, where they saw a strong credit story, and into mezzanine RMBS transactions where AAs were picked up at a spread of 2.7%. During the month, the team also extended the allocation to Australian ABS, where record levels of primary supply have been keeping spreads relatively stable and attractive on a currency-adjusted basis.

The Fund returned 1.21% for the month (Class A Inc), with three-year volatility at 3.83%.

Market Outlook and Strategy

The market will remain focused on comments from central bankers and economic data to assess the likely timing of upcoming rate cuts. The continuing strong economic data in the UK and Europe has increased the likelihood of cuts being delayed, although at the time of writing we expected the ECB to move first. Spread products continue to perform well, and with the absence of geopolitical escalation or a sharp macroeconomic decline, we expect this strong supply-demand technical to persist in the medium term. The portfolio managers expect the current strength in both supply and demand to remain in place, and take signs of some spread resistance by investors as a sign that ABS markets will be more rangebound in the short term. In the longer term, we continue to see geopolitical risk as the key risk for market volatility and, while the team do not see a catalyst for short-term volatility, they value flexibility and continue to see the attractiveness of AAAs (particularly in UK prime and CLOs) as well as primary mezzanine CLO tranches.

					Annualised			
Cumulative Performance	1m	3m	6m	1y	3y	5y	10y	Since Inception*
A Acc GBP	1.21%	3.11%	7.48%	13.65%	6.29%	N/A	N/A	6.21%
SONIA	0.44%	1.32%	2.64%	5.26%	2.77%	N/A	N/A	2.20%

Discrete Performance	YTD	2023	2022	2021	2020	2019	2018	2017	2016	2015	2014
A Acc GBP	5.85%	14.27%	-2.11%	3.59%	N/A	N/A	N/A	N/A	N/A	N/A	N/A
SONIA	2.19%	4.71%	1.41%	0.05%	N/A	N/A	N/A	N/A	N/A	N/A	N/A

Based on the A Inc GBP share class from inception on 20 August 2020 before switching to A Acc GBP share class following its inception on 2 November 2020. Switch in reporting share class was made for ease of reporting. Past performance is not a reliable indicator of future performance. The performance figures shown are in GBP on a mid-to-mid basis inclusive of net reinvested income and net of all Fund expenses. Performance data does not take into account any commissions and costs charged when shares of the Fund are issued and redeemed. The value of an investment and the income from it can fall as well as rise as a result of market and currency fluctuations and you may not get back the amount originally invested. *Inception date 20/08/2020.

Key Risks

- Limited participation in the potential of single securities
- Investments in foreign currencies are subject to currency fluctuations
- Success of single security analysis and active management cannot be guaranteed
- It cannot be guaranteed that the investor will recover the capital invested
- The structure of ABS/MBS and the pools backing them might not be transparent which exposes the Fund to additional credit and prepayment risks (extension or contraction risks) depending on which tranche of ABS/MBS is purchased by the Fund
- Typically, sub-investment grade securities will have a higher risk of default, and are generally considered to be more illiquid than investment grade securities
- The Fund has the ability to use derivatives, including but not limited to FX forwards, for hedging and EPM purposes only. This may magnify gains or losses
- The Fund's investments may be subject to sustainability risks. The sustainability risks that the Fund may be subject to are likely to have an immaterial impact on the value of the Fund's investments in the medium to long term due to the mitigating nature of the Fund's ESG approach
- The Fund's 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 Fund may be obtained from **www.twentyfouram.com/responsible-investment**

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Further information on fund charges, costs and other important information pertaining to the fund can be found in English and free of charge on the fund pages of our website and/or in the relevant offering documents available at www.twentyfouram.com/document-library