TwentyFour
a boutique of Vontobel

Fund Commentary | 31 October 2023

Vontobel Fund - TwentyFour Sustainable Short Term Bond Income

This Commentary is a marketing communication for professional UK investors only

Market Commentary

October was another difficult month for financial markets, with rates volatility continuing and a significant increase in geopolitical risks. With investor sentiment weaking, and treasuries no longer acting as an automatic safe haven, alternative monetary assets bitcoin, gold and silver benefited the most, being 26%, 7% and 3% higher respectively over the month. Equity markets continued their recent weakness, with the S&P 500 falling 2% in October, its third successive negative month, while the DAX and FTSE 100 were both lower by 3.7%.

The month started with treasuries continuing their recent weakness, and the yield on the 10-year maturity reached almost 4.9% intraday, as strong economic data out of the US (including PMIs, ISMs, JOLTs, and non-farm payrolls, which were all ahead of consensus) depressing bullish sentiment and calling into question whether base rates had yet peaked. Treasury yields pulled back briefly after the terrorist attack in Israeli on 7 October, with an investor flight to quality benefiting rates as fears of a broader conflict in the Middle East grew. In addition, the aggressive sell off in treasuries, which saw a 55 basis points (bps) yield increase between the 20 Sept rate decision and early October, brought a plethora of comments from Federal Reserve (Fed) members, noting that the move in yields was "doing their job for them", and that they could afford to be patient, given that base rates were already restrictive. With speculation that this rhetoric could alter the Fed's interest rate expectations (the dot plot) to the downside, reducing the chances of another hike, the rates selloff briefly found some respite.

However, with the strong economic data continuing, and inflation, in particular, remaining elevated, and with confidence that the diplomatic efforts in Israel could prevent an escalation across the region, rates resumed their sell off, and the 10-year maturity breached 5% intraday, on 23 October, a level last seen in 2007. In addition to the strong economic data, there were a number of negative technical drivers also weighing on yields; the large borrowing estimates from the Treasury gained significance, as did the mix of maturities, coupled with notable holders such as China and Japan reducing their holdings, and treasury auctions performing poorly. Furthermore, a term premium returned to yields as investors sought higher compensation for the elevated risks attached to holding treasuries.

Towards the end of the month, the US reported annualised quarter-on-quarter GDP growth of 4.9%, well ahead of the expected 4.5%, and coming on top of very strong retail, durable goods and house sales data. All helped to reinforce the view that the US economy was remaining very resilient, even in the face of the aggressive rate hiking policy. However, although official economic data remained resilient, private data, such as credit card and auto loan delinquencies and defaults, began to move upwards, and the feeling persisted that the US consumer was weakening.

In Europe, economic data was very different to that reported in the US, with PMIs remaining weak, retail sales remaining negative and below consensus, and CPI continuing to fall. The European Central Bank (ECB), as expected, kept the main refinancing rate at 4.50% and, although president Lagarde reiterated the higher-for-longer mantra, she did acknowledge that growth was weak and mentioned the ECB was keeping a close eye on financial stability, amid the rise in long-term yields. The weaker data and lower inflation increased expectations that the ECB was close to peak rates, which helped German bunds during the month. While US rates sold off, bunds held firm, with yields marginally lower by the end of the month, the 10-year bund finishing at 2.8%.

In the UK, the economic data, on the whole, came in below consensus, with manufacturing and industrial production especially weak. Inflation, however, remained sticky, although retail continued to report falling food prices and CPIs were expected to drop over the coming months. The weak data also encouraged investors that the Bank of England (BoE) may be close to peak rates and, similar to bunds, UK gilts managed to end the month with only slightly higher yields, with the 10-year at 4.5%

Away from macro-economic data, the third quarter earnings season kicked off in early October, with results once again mostly beating expectations. Bank results were particularly closely followed, with investors looking for signs of consumer weakness. However, the large US banks mostly reported healthy deposit balances, although Bank of America CEO Brian Moynihan highlighted that spending was slowing, indicating that the economy was also slowing. In the UK and Europe, banks reported stellar results, with net interest margins continuing to climb in Europe while having stabilised in the UK. Overall, bottom lines were generally very strong, balance sheets were robust, with most banks reporting lower provisions as non-performing loans (NPLs) stayed low, and capital levels were higher, with banks continuing to look to share buybacks to reward equity investors.

Portfolio Commentary

With government bond yield curves continuing to steepen in October, the front end of curves did relatively well, and the Fund had a positive return of +0.39%, taking year-to-date returns to +4.01%. Attribution for the month shows the portfolio's underweight duration positioning, and yield curve preference for one-year and two-year bonds versus the most inverted part of the yield curve (three- to five-year) led to alpha generation versus short-dated rates indices and generated positive returns across all sectors.

Strength was fairly broad-based, with floating rate asset-backed securities (ABS) having a strong month and a total return of +0.55% and a contribution to the Fund's performance of +4bps. Next, Bank sector AT1s delivered a total return of +0.58%, with Banks overall returning +0.43%, contributing +10bps. Government bonds also had a strong return at +0.47% and a contribution of +7bps. Similar to last month, the UK gilts held in the portfolio outperformed the US treasuries, returning +0.62% versus an average of +0.40%.

Non-financials were slightly behind government bonds, returning +0.34% and contributing +7bps, with strength broad based across Telcos, Utilities and other industrials (although we remain underweight heavy/more cyclical industrials compared to most reference indices). Similarly, we remain uninvested in problematic sectors such as high street retail and commercial property, where we think there are risks of downgrades from investment grade (IG) to high yield (HY) in those sectors against a backdrop of deteriorating economic fundamentals. Lastly, corporate hybrids returned +0.08%, with Telcos and energy distribution companies doing well, whereas transportation underperformed.

Whilst a softer landing narrative appears to be increasing in terms of adoption by market participants, the Fund retains a continued lower beta stance than normal given non-financial spreads that, in the views of the portfolio managers, are starting to look a little too tight for economic risks that still remain significant. Likewise, spread duration remains lower than normal at 1.4 years, with around 15% in our liquidity bucket – of government bonds (US treasuries and now gilts), supranationals and cash – also being higher than normal. Further, given the PMs' concerns over Commercial Real Estate (CRE) issues in the US having the potential to create further insolvencies in the US Regional Banking sectors, the PMs retained higher credit quality within both the Banks and Insurance sectors 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. Over the next few months, as we await further clarification on the likely tightening of monetary conditions from stricter lending standards in the banking sector, the PMs believe there will opportunities to add beta – but that right now is not the time to add significant portfolio risk.

Market Outlook and Strategy

With the Fed, BOE and ECB now appearing to be at terminal rates, the risks to capital from duration risk are believed to be receding – but the significant yield curve inversion in rates curves still makes the three- to five-year maturity sector look especially expensive in our view, even allowing for the potential for rate cuts later next year. As such, a lower-than-average duration profile is still thought to be warranted, with peak yields being less than 2 years to maturity, and that is predominantly where the Fund is focusing. As duration risks start receding, however, the PMs are concerned that increasing unemployment rates across the US, UK and especially Germany signal worsening GDP data to come – and that recession risks, which we believe remain significant, are not fully priced into non-financial spreads. Therefore, a lower beta credit stance is still warranted in our view.

As such, we believe the combination of very low duration and high average yield, with high average credit quality, make short-dated IG 'the best game in town' for 2023 and the next 12 months. This is predominantly due to the very high breakeven yield the portfolio now exhibits, with a yield of 6.51% and a duration of 1.50 years meaning the breakeven yield is some +434bps. Although the PMs fully expect volatility to remain in markets for some months yet, a scenario where the portfolio yield rises by more than +430bps to ~11% over the next year seems very remote, and as such the probability of positive total returns over the next 12 months is believed to remain high. In these markets, we appreciate having access to portfolio managers is more important than in 'normal' times. Therefore, we would encourage you to reach out to your sales contacts and set up meetings with the PMs to go through anything you would like in more detail.

Cumulative Performance	1m	3m	6m	1y	Annualised 3y	5y	10y	Since Inception*
Class G	0.39%	1.31%	2.24%	5.63%	0.31%	N/A	N/A	0.38%
SONIA + 250	0.65%	1.95%	3.80%	6.98%	4.32%	N/A	N/A	3.99%

Discrete Performance	YTD	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013
Class G	4.01%	-4.21%	0.24%	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
SONIA + 250	5.99%	3.97%	2.59%	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A

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 22/01/2020.

Key Risks

- Limited participation in the potential of single securities
- Success of single security analysis and active management cannot be guaranteed
- It cannot be guaranteed that the investor will recover the capital invested
- Derivatives entail risks relating to liquidity, leverage and credit fluctuations, illiquidity and volatility
- Interest rates may vary, bonds suffer price declines on rising interest rates
- High-yield bonds (non-investment-grade bonds/junk bonds) may be subject to greater market fluctuations, risk of default or loss of income and principal than higher-rated bonds
- 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

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The Fund considers environmental, social and governance (ESG) factors in the investment process, utilising an integrated approach.
Information on the integration approach may be obtained from **https://www.twentyfouram.com/responsible-investment-policy**

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

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