TwentyFour
a boutique of Vontobel

Fund Commentary | 30 August 2024

Vontobel Fund – TwentyFour Absolute Return Credit Fund

This Commentary is a marketing communication for professional UK investors only

Market Commentary

August was a highly volatile month for fixed income and equity markets alike. At the beginning of the month, the US labour report sparked recessionary fears and prompted negative market sentiment. However, these concerns were quickly offset by strong economic data showing the US economy was still performing well. Although the data resulted in a sharp rebound in government bond yields and equity indices, the repercussions of the weak jobs report were present throughout the month as investors priced a more aggressive rate-cutting cycle by the US Federal Reserve (Fed) and other major central banks.

As with every month, the first Friday of August provided investors with the monthly US jobs report. However, in contrast to previous months, the labour market showed significant signs of weakening. The unemployment rate came in at 4.3% (higher than the expected reading of 4.1% and up from 3.7% at the beginning of the year), while non-farm payrolls printed at 114k, which was well below the anticipated 175k figure. In the immediate aftermath of the release, recessionary fears gripped markets, and economists began calling for meaningful action by the Fed in the form of rate cuts. Confidence of a soft landing diminished, which resulted in sharp negative moves across global equity markets, government bonds benefiting from a flight to quality, and growing expectations of a more aggressive rate-cutting cycle, with 10-year Treasuries having rallied to a yield of as low as 3.70%.

However, as the month unfolded, economic data pointed towards a US economy that was still performing well and, as a result, market sentiment began to improve. The supportive data included a very strong retail sales print, with the headline number accelerating to +1% month-on-month in July, significantly higher than the +0.4% expected and the fastest monthly retail sales increase since the beginning of 2023. The Fed also received positive news on the inflation front in August, with headline consumer price inflation undershooting expectations on a year-on-year basis, rising 2.9% (versus an expected 3%), which represents the slowest print since March 2021. Core inflation was in line with consensus at 3.2% at the year-on-year level. The revised estimates of second-quarter US GDP helped in painting an increasingly positive story for domestic economic growth. The headline GDP number was revised upwards to an annualised growth rate of 3% from 2.8% previously, and the Atlanta Fed increased its third-quarter GDPNow estimate to 2.5%. Nevertheless, Jerome Powell's speech at Jackson Hole at the end of August saw several dovish comments that all but confirmed the Fed will be cutting rates at its upcoming central bank meeting in September. Powell said "the time has come for policy to adjust" and acknowledged that "downside risks to employment have increased", suggesting the Fed is shifting its focus away from inflation and towards the employment side of the economy. Powell noted the recent uptick in the unemployment rate has been driven not just by weakening labour demand but very strong supply. He described the cooling in labour market conditions as "unmistakable", which resulted in markets increasing the probability that the Fed would execute a 50 basis point (bps) interest rate cut in September to 33% by the end of the month.

In the UK, the Bank of England (BoE) delivered its first interest rate cut in four years at the beginning of the month, with the 25 bps move made on a knife-edge 5-4 vote. Similarly to the US, the UK had a soft inflation report. The headline number came in one-tenth below market expectations on both a monthly and annual basis, while core CPI also surprised on the downside, ticking down to 3.3% from 3.5% in the previous month. Services inflation fell noticeably from 5.7% in June to 5.2% in July, well below consensus expectations of 5.5%. UK unemployment also surprisingly fell to 4.2% in the second quarter, down from 4.4% in the first quarter, with the monthly reading of 3.6% for June representing the lowest reading since February 2022. Despite cutting rates at the beginning of August, the BoE struck a cautious tone at its last meeting and did not commit to further cuts in the near term, reiterating that it is now more focused on broader trends than individual data points.

In Europe, the preliminary headline CPI release for August was in line with expectations at 2.2%, as was core inflation at 2.8%. This figure represents the eurozone's lowest inflation figure for three years, opening up the opportunity for a second European Central Bank (ECB) rate cut in September, which the market is fully pricing in. There remain some doubts over the eurozone's future economic growth prospects over the medium term. However, reassuringly, second-quarter GDP came in line with expectations at 0.6% year-on-year. Moreover, Purchasing Managers' Indices (PMI) posted a significant outperformance relative to expectations, with the composite PMI reading coming in at 51.2 (50.1 expected), supported by a strong reading from France amid the Olympics.

Portfolio Commentary

With a steady backdrop for rates and credit, despite some equity volatility during the month, the Fund returned +0.54%, net of fees. This takes the year-to-date returns to +4.26%, some +80 basis points (bps) higher than the 1-5Yr Sterling Corporate Index.

Remarkably, and similar to last month, every bond in the portfolio was up in August, except for one: a five-year US Treasury bond that was added during the month. Therefore, all sectors were in the green again for a second month.

Given a good month for risk assets, it was the higher beta sectors of Additional Tier 1s (AT1) and corporate hybrids that led the credit pack, delivering +0.92% and +0.71%, respectively. Government bonds also had another strong month, returning +0.90%.

Financials returned +0.49%, contributing 21bps to the Fund's total return. Overall, banks were up +0.46%, with AT1s strongly outperforming, delivering more than double the returns of the other sub-sectors; senior banks and Tier 2s returned +0.39% and +0.44%, respectively. Insurance pipped banks, returning +0.54%, with subordinated insurers delivering +0.56% against +0.30% for the higher quality Tier 3 sub-sector.

Government bonds were the second best returning sector, contributing +14bps to the Fund's total return. The five-year bund returned +0.45%, while the five-year US Treasury bonds that were owned for the entire month returned nearly +1.5%. The latest addition to the sector, the 4% July 2029 US Treasury, was down -0.17% given it was bought late in the month.

The floating rate asset-backed security sector returned just below the portfolio average at +0.49%, while senior non-financial corporates returned the lowest of all credit sectors at +0.46%, contributing +9bps.

The Fund retains a continued lower beta credit stance than normal given non-financial spreads, which, in the portfolio managers' (PM) views, are starting to look too tight for the economic risks that still remain significant. Likewise, spread duration remains lower than normal at 1.4 years, but interest rate duration is now close to two years, with around 15% in our liquidity bucket of government bonds (US Treasuries and now bunds). Further, the PMs are concerned over Commercial Real Estate (CRE) issues in the US having the potential to create further insolvencies in the US regional banking sector. As a result, they have 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, they believe 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 retain a lower level of risk in financials, keeping the overall beta of the Fund slightly lower than before these CRE concerns materialised.

Market Outlook and Strategy

With the ECB having delivered the first rate cut for this cycle in June, and with the BoE following suit on 1 August, it is likely that the Fed will also cut in September after recent dovish commentary. As such, the major risks to capital from duration risk look to have ended. Therefore, the PMs have continued to become more tolerant of duration in the Fund, taking interest rate duration up to 2.0 years, as noted earlier (please note this was described in detail in a recent webinar "The Duration Deliberation", which remains available on our website). However, on the flip side, the remaining yield curve inversion in rates curves and tight credit spreads in some sectors still give the PMs concerns about adding credit spread duration into the Fund right now, with the biggest capital gains thought likely to be in short dated bonds. As such, a modestly lower than average duration profile is still believed to be warranted, with peak yields still being less than two years to maturity – that is predominantly where the portfolio is focusing. However, as duration risks start receding, the PMs are concerned that increasing unemployment rates across the US, UK, and especially Germany signal worsening GDP data to come. Moreover, recession risks both remain significant and are not fully priced into non-financial spreads, in the PMs' views. Therefore, a lower beta credit stance is also still thought to remain warranted, although the prospect of further rate cuts suggests total returns from short dated credit can still remain attractive for some time yet.

In summary, we believe the combination of low duration and high average yield, with high average credit quality, make short dated investment-grade a good risk/return opportunity. This is predominantly due to the very high breakeven yield the portfolio now exhibits, with a yield of 5.15% and a duration of two years, meaning the breakeven yield is nearly +260bps. Although the PMs fully expect some volatility to remain in the market for some months yet, a scenario where the portfolio yield rises by more than +2.6% to 8% over the next 12 months seems remote in their view. 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 PMs 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 like in more detail.

Cumulative Performance	1m	3m	6m	1y	Annualised 3y	Annualised 5y	Annualised 10y	Annualised Since Inception*
Class G Acc	0.54%	2.25%	3.61%	8.08%	1.45%	1.84%	N/A	2.56%
SONIA + 250	0.61%	1.92%	3.91%	7.97%	5.82%	4.59%	N/A	3.87%

Discrete Performance	YTD	2023	2022	2021	2020	2019	2018	2017	2016	2015	2014
Class G Acc	4.26%	6.08%	-4.80%	0.52%	2.47%	5.02%	-0.83%	5.25%	4.99%	N/A	N/A
SONIA + 250	5.24%	7.36%	3.97%	2.59%	2.73%	3.26%	3.11%	2.79%	2.91%	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, if applicable. 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: 28 August 2015. SONIA used as a proxy for cash as a performance reference for illustration purposes only, there is no specific return objective or benchmark for the fund.

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-Fund's investments in the medium to long term due to the mitigating nature of the Sub-Fund's ESG approach
- The Sub-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 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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