

# Vontobel Fund – TwentyFour Absolute Return Credit Fund

This Commentary is a marketing communication for professional UK investors only

## Market Commentary

September was characterised by a material repricing in the market's expectations for the future path of interest rates, with investors pricing in a more aggressive rate-cutting cycle by major central banks. This led to a bull steepening of yield curves and helped drive strong returns across a host of sectors within fixed income. Encouraging data out of the US supported the soft landing narrative, while economic growth in large parts of the Eurozone continued to weaken.

Given the weaker than anticipated labour data out of the US in August, the US jobs report at the beginning of September was a key date in investors' diaries last month. The highly anticipated report provided something for everyone. The unemployment rate ticked down to 4.2% from 4.3% previously (as expected), but non-farm payrolls (NFP) only rebounded to +142k, below the forecasted +165k figure. This came alongside downward revisions to NFP numbers for both July and June, which drove the narrative that the US labour market is still seeing tangible signs of weakening. Volatile moves followed the report on the rates side, with the 10-year Treasury yield dropping by almost 20 basis points (bps) over the week to 3.71%, representing the lowest closing level since June 2023. The 2s10s curve rose into positive territory following the report, marking the end of the latest period of Treasury curve inversion that dated back to July 2022. US headline consumer price inflation (CPI) later in the month came in at 0.19%, taking the year-on-year figure down to 2.5%, which was in line with expectations but represented the lowest annual rate since February 2021. However, there was an upside surprise for core inflation, which printed at +0.28% on a month-on-month basis, primarily driven by an uptick in owner equivalent rent, which came in at a seven-month high of +0.5% for August alone. Despite the labour market and inflation reports coming broadly in line with expectations, reports from well-sourced journalists suggesting a 50bps interest rate cut was on the table for the US Federal Reserve (Fed)'s September meeting fuelled a growing and subsequently dominant narrative that the Fed would indeed deliver a half-point cut. The Federal Open Market Committee (FOMC) eventually did announce a 50bps interest rate cut, marking the beginning of the cutting cycle for the US central bank as it lowered the Fed funds rate to 5%. The decision was split 11-1, with member Michelle Bowman becoming the first Fed governor to dissent since 2005, opting for a 25bps cut instead. The FOMC also revealed downward revisions to inflation projections, with 2025 personal consumption expenditures (PCE) lowered by 0.2% to 2.1%, and upward revisions to the unemployment rate forecast to 4.4% from 4.2% previously. Updated dot plot projections showed that the median FOMC member expects the Fed to cut by a further 50bps to 4.5% by year-end and 3.5% by the end of 2025, which was more hawkish than what the market was perhaps expecting. US economic data in the days following pointed towards the US economy remaining resilient and inflationary pressures being kept under control. Retail sales were stronger than anticipated at +0.1% versus -0.2% expected and headline PCE inflation printed marginally below expectations at +2.2% on a year-on-year basis versus the expected +2.3% figure (the lowest reading since February 2021). In line with Fed commentary throughout September, the data served as further evidence that inflation is being tamed, although the battle is not yet completely won.

In Europe, the European Central Bank (ECB) delivered a 25bps rate cut, in line with market expectations, reducing its deposit rate to 3.5%. Updated forecasts showed marginally downgraded growth projections to +0.8% for year-end 2024, +1.3% for 2025 and +1.5% for 2026. Headline inflation forecasts were kept unchanged, but core CPI forecasts were raised. Purchasing Managers' Indices (PMI) towards month-end were very weak, with signs of significant economic weakness across large parts of the Eurozone. The Eurozone's composite PMI figure printed at 48.9 in September, down from 51.0 in August and materially underperforming the 50.5 expectation, driven by a continued decline in manufacturing activity across the bloc. The print led some investment banks to downwardly revise their GDP forecasts for the Eurozone for the remainder of the year. Markets began pricing in another quarter-point rate cut by the ECB in its October meeting as weak economic data emerged.

The Bank of England (BoE) bucked the trend and kept its policy rate unchanged at 5% last month, with members voting 8-1 in favour of holding rates, broadly in line with market forecasts. The announcement followed UK headline CPI coming in line with expectations at +2.2%. However, core inflation ticked up to 3.6% on a year-on-year basis, with the move largely driven by an increase in services inflation to 5.6% from 5.2% previously. In light of this, Governor Andrew Bailey stated that BoE members "need to be careful not to cut too fast or by too much" as core inflation is still running significantly higher than the bank's 2% target. Economic activity is not yet showing signs of material weakening in the UK; strong PMIs suggest net economic expansion as the composite figure printed at 52.9 and retail sales outperformed economist forecasts at +1% month-on-month. On the labour side, the unemployment rate fell by one-tenth to 4.1% in September, as did average weekly earnings to 4.0% on a year-on-year basis.

## Portfolio Commentary

With the Fed's 50bps cut and further economic weakness in Europe, rates positions in the Fund did particularly well, with the Fund generating a return of +0.68% (after fees) over the month. This takes the year-to-date returns to +4.97%, +80bps higher than the 1-5-Year Sterling Corporate Index.

Government bonds led returns, with both the five-year positions in US Treasuries and German bunds doing well. Bunds outperformed slightly given poor economic data in Germany. Overall, government bonds returned +1.06%, contributing +16bps, with bunds returning +1.16%.

Financials returned +0.74%, contributing +32bps to the Fund's total return, with the insurance sector edging banks by delivering +0.93% versus +0.65%. However, in both cases, subordinated sub-sectors led returns over senior. Subordinated insurance returned +0.94%, with subordinated Tier 2 banks delivering +0.73%, while senior banks produced +0.60%.

Hybrid corporates also continued to outperform their senior equivalents. Hybrids returned +0.57% compared to +0.49%, and there was strength across the sector, with no particular stocks standing out.

The secured sector returned more than senior non-financials, returning +0.63%, with no surprises. This may seem like a strange comment, however, the broader secured sector continues to be rocked by the fallout from Thames Water, whose entire secured bond stack was downgraded to CCC in September, and thus formally exited investment grade (IG) indices at the end of the month (Thames has not been held in any TwentyFour IG funds for many years).

Lastly, the floating-rate asset-backed security (ABS) sector returned just below the portfolio average at +0.58%. This was a decent return, however, given the broader landscape for fixed versus floating is now turning back to fixed at the front end of the yield curve, the portfolio managers (PMs) have continued to let the ABS sector weighting gently trend down to its current 5% level, as maturing bonds are not replaced in the ABS sector, having been one of the best-performing sectors over the last two years.

The Fund retains a continued lower beta credit stance than normal given non-financial spreads which, in the PMs' view, are starting to look too tight for the economic risks that still remain significant – and even deepening. 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. Thus, 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, 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 these CRE concerns materialised.

## Market Outlook and Strategy

With the ECB having now delivered its second interest rate cut, and the Fed cutting rates by 50bps in its first rate cut this cycle, the prospects for repeated cuts now look excellent through 2024 and 2025. As such, the major risks to capital from duration risk look to have ended; the PMs have continued to become more tolerant of duration in the Fund, taking interest rate duration up to 2.0 years, as mentioned 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 cause the PMs concern 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, the PMs believe modestly lower than average duration profile remains warranted, with peak yields still being less than 2 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 remain attractive for some considerable time yet.

In summary, we believe the combination of low duration and high average yield, with high average credit quality, still make short-dated IG a fantastic risk/return opportunity. This is predominantly due to the very high breakeven yield the portfolio now exhibits, with a yield of 5.28% and a duration of 2 years, meaning the breakeven yield is nearly +265bps. Although the PMs fully expect some volatility in market for some months yet, a scenario where the portfolio yield rises by more than +2.65% to 8% over the next 12 months seems remote in our 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			Since Inception*
					3y	5y	10y	
Class G Acc	0.68%	2.36%	3.51%	8.20%	1.77%	1.93%	N/A	2.61%
SONIA + 250	0.61%	1.92%	3.89%	7.97%	5.97%	4.66%	N/A	3.91%

Discrete Performance	YTD	2023	2022	2021	2020	2019	2018	2017	2016	2015	2014
Class G Acc	4.97%	6.08%	-4.80%	0.52%	2.47%	5.02%	-0.83%	5.25%	4.99%	N/A	N/A
SONIA + 250	5.90%	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](http://Vontobel.com/SFDR)

## Fund Managers



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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](http://www.twentyfouram.com/document-library)**

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