

Fund Commentary | 29 February 2024

Vontobel Fund – TwentyFour Monument European Asset Backed Securities

This Commentary is a marketing communication for professional UK investors only

Market Commentary

February was yet another month of conflicting economic data for investors to digest, but ultimately one where risk assets performed strongly, especially equity markets, with the S&P 500 going through 5,000 for the first time and the Nikkei finally getting back to 1989 highs. Tech companies were the main drivers behind equity indices reaching new highs, with the hype surrounding artificial intelligence (AI) continuing to drive very strong performance, and Nvidia added almost \$0.5tn to its valuation in February alone.

Kicking off the month in the US, ISM manufacturing, new orders and prices paid all came in well ahead of consensus, and, the following day, nonfarm payrolls added 353k jobs, when only an addition of 185k was expected, while the unemployment rate fell to just 3.7%. In addition, average hourly earnings were much stronger than expected and reinforced the message that inflation was likely to be sticky and that the easier progress had already been made. Inflation data for January, which was reported mid-February, supported this, with headline and core CPI coming in hotter than expected, for both monthly and yearly readings. In reaction to this, Treasury yields, which had fallen at the end of January on renewed fears around US regional banks (New York Community Bank equity down 25% for the month), began to climb; 10-year Treasury yields, which started the month at around 3.9%, reached year-to-date highs of 4.32%, as projections of interest rate cuts were moved further into 2024. Along with strong economic data and sticky inflation, US Federal Reserve (Fed) officials continued to play down any imminent cuts to base rates, with official after official emphasising the need to be patient while inflation came closer to target, as the economy remained robust.

In Europe, economic data continued to be mixed, supporting the view that rates could be cut sooner than in the US. However, European Central Bank (ECB) officials echoed the message from the Fed and stuck to the line that they needed to be patient until prices were under control; they pointed to wage expectations remaining high as a reason to stay restrictive. As the month wore on, manufacturing and services Purchasing Managers' Index (PMI) numbers came in ahead of expectations, adding to rhetoric that rate cuts could be slow to emerge in the EU, while regional CPI numbers at month end also suggested that inflation, which had fallen rapidly, was becoming stickier. In response to the better data, and to the move higher in Treasury yields, German bund yields also climbed over the month, with the 10-year maturity yield increasing from 2.16% to 2.40%. In the UK, economic data was even more mixed, with inflation data coming in lower than expected and the Office for National Statistics confirming the UK entered a technical recession in H2 2023. However, the consumer remained strong and average weekly earnings remained higher than expected.

All in all, the strong data continues to surprise market commentators, meaning that rate cut expectations are being re-examined and in the US over 50 basis points (bps) of expected cuts were removed for 2024, while 45bps of cuts were removed from the German bund curve.

General

ABS markets performed well over February, as spreads remained attractive on a risk-adjusted basis and elevated base rates supported attractive all-in yields. The continued support of the macroeconomic environment has meant collateral performance has remained healthy, and deterioration is limited to risk pockets such as pre-Global Financial Crisis (GFC) mortgage collateral or office commercial mortgage-backed securities (CMBS). Primary markets remain healthy, particularly with CLOs, where February was the busiest month for nearly two years. Cumulative ABS issuance sits ahead of 2023, with €8.5bn of paper placed so far. February welcomed a higher share of mezzanine issuance, pushing the AAA share to 81% for 2024, a welcome trend for investors. January saw a strong rally in spreads as the market was searching for the new clearing levels. February proved to be more stable in AAA spreads, but generally mezzanine spreads rallied and primary supply was met with very high levels of oversubscription in RMBS and consumer ABS transactions. The team continues to

see dispersion in collateral performance across different jurisdictions, with Germany underperforming other European countries, for instance, but signs of stabilisation have started to emerge.

RMBS

RMBS markets remained active through February, albeit solely out of the UK, where cumulative issuance now sits at €3.9bn for 2024. We saw two UK non-conforming deals print at opposing ends of the month, which provides a good insight into the shape of RMBS curves. During the first days of the month, we had a deal from West One Loans where AAAs printed at a spread of 112 basis points (bps) over SONIA, and BBBs at a spread of 275bps. In line with the supply and demand imbalance for mezzanine paper now, we expected a well-covered book, and subsequent tightening for the deal. The scale at which this was done, however, was surprising, as the B tranche was left with a coverage of just 1X after tightening to a spread of 145bps from talk of the mid-to-high 100s. The second deal, three weeks later, was from specialist lender Polaris. AAAs here printed at 103bps, and BBBs at 270bps, with final subscription on all tranches healthy, BBBs ending 6.6X oversubscribed. One thing to note has been the unexpected lull in bank prime RMBS issuance. We believe that this will be short-lived and expect a healthy supply again before Easter.

CLO:

February was a busy month for CLO primary markets, where we had the busiest month since March 2022 with 12 deals coming to market, putting year-to-date (YTD) volumes 24% ahead of 2023. This scale of supply has meant that levels remained relatively flat during the month, with AAAs firm at 150bps over Euribor, which still looks attractive on a historic basis. Although there is a wider range in BBB and BB spreads, due to the quality of managers, spreads are sitting around 400 and 700bps over Euribor (with Signal's second CLO being the exception which priced generally 25-50bps wider). As CLO supply remains at relatively high levels, the portfolio managers (PMs) believe that the market has reached a steady state at current levels and do not see a short-term catalyst for spreads to move significantly tighter or wider. The most active managers are the managers that have dedicated AUM buying equity, as we see that the hedge funds' bid for CLO equity does not support the current CLO arbitrage. The team has taken the opportunity to re-underwrite newer managers that now have multiple years of track record, but remains cautious of new managers with small loan teams, as the team sees an increased amount of management turnover. As the 2024 cost of funding now looks attractive for managers, we are seeing an uptick in the number of refinancing deals of the 2022 and 2023 vintages, as well as from older transactions that have reached the end of their reinvestment periods, and we expect this trend to continue.

Other ABS:

Outside of RMBS and CLOs, we have seen a fair supply of European Auto ABS. This included a rarer consumer deal from Belgium; being the first full-cap stack consumer deal, it framed a new curve and was well absorbed with strong coverage on all mezzanine tranches. We also saw three auto deals print, with German autos closing at 43bps, a few basis points tighter than in January. The pipeline for ABS looks healthy into March, and these deals will provide a clear starting point for levels.

Secondary markets:

February was a busy month for secondary markets for both ABS and CLOs, albeit more sporadic for ABS markets. CLO volumes were consistently healthy, with ~€400m on BWIC per week and with investors rotating into primary supply. There was a shift away from the usual AAA dominance in February, as participants continued to clip profits in higher risk CLO profiles, reflecting a usual contribution by BBBs of 18% of total trading. ABS trading was characterised by UK dominance; as large clips of UK RMBS traded on auction lists, we noted increased volumes in very short maturities. Secondary ABS markets have also been dominated by AAA paper; the demand for mezzanine bonds remains very strong, with very little selling, and generally spreads tightened across the board.

Portfolio Commentary

February was a busy month for the Fund, as the portfolio management team deployed inflows into the primary markets. The team capitalised on spread tightening since the beginning of the year, and sold BBB Euro CLOs at a yield of 3% over Euribor. The proceeds were deployed in the primary market, particularly in AAA CLOs, where spreads looked cheap on a historical basis, at 150bps over Euribor. Outside of CLOs, the team saw the primary market as an attractive opportunity to add to the liquidity bucket of the Fund. Here, the team bought AAA Euro paper at a yield of 0.4% over Euribor. February also saw the first addition of Australian prime RMBS to the Fund, which continued to look attractive on a currency-adjusted basis, offering a pickup of around 35bps from European prime RMBS. As macro data continue to surprise to the upside, collateral performance remains healthy, and the consumer remains resilient.

The Fund returned 0.64% for the month (Class I EUR) with 3yr volatility at 2.83%.

Market Outlook and Strategy

Spreads products performed very well in February, and, without further escalation of geopolitical risks, we expect this strong supply-demand technical to persist in the medium term. The team sees best value in primary AAA CLOs and short-dated BBB- and BB-rated RMBS and CLOs. We expect the pace of Euro CLO issuance to persist and envisage a healthy ABS pipeline for March. We expect resistance to spreads tightening from here, though we also see a scenario where the excess demand, particularly in ABS markets, outweighs this effect. Primary supply has been met with very strong demand so far in 2024, and, although total volumes are strong, the team expected to see more RMBS deals come to market, but recognise that specialist mortgage lending volumes have likely been suppressed in the last 12 months. In the longer term, we continue to see geopolitical risk as the key risk for market volatility, and, while the portfolio managers do not see a catalyst for short-term volatility, they value flexibility in positioning, and therefore expect to keep elevated levels of liquidity, especially as European ABS continues to benefit from higher rates for longer.

Cumulative Performance	1m	3m	6m	1y	Annualised					Since Inception¹
					3y	5y	10y			
I EUR	0.64%	2.89%	4.39%	7.60%	2.09%	1.72%	N/A			1.44%
3 month Euribor	0.31%	0.98%	1.98%	3.74%	1.33%	0.63%	N/A			0.39%

Discrete Performance	YTD	2023	2022	2021	2020	2019	2018	2017	2016	2015	2014
I EUR	1.89%	8.43%	-4.54%	1.73%	-0.14%	2.05%	-1.14%	N/A	N/A	N/A	N/A
3 month Euribor	0.65%	3.49%	0.34%	-0.55%	-0.42%	-0.36%	-0.32%	N/A	N/A	N/A	N/A

Past performance is not a reliable indicator of future performance. The performance figures shown are 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 27/06/2017.

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
- 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
- The structure of ABS/MBS and the pools backing them might not be transparent which exposes the sub-fund to additional credit and prepayment risks (extension or contraction risks) depending on which tranche of ABS/MBS is purchased by the sub-fund
- 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](https://www.vontobel.com/SFDR)

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For definitions of the investment terminology used within this document please see glossary at: twentyfouram.com/glossary

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