

Vontobel Fund - TwentyFour Sustainable Short Term Bond Income

This Commentary is a marketing communication for professional UK investors only

Market Commentary

June was another volatile month for rates as mixed economic data releases and increased political uncertainty led to wavering market sentiment. Credit spreads widened marginally off the back of this uncertainty. However, US equities continued their impressive year-to-date rally, while rates across both Europe and the US returned positive performance despite a late sell-off at the end of the month.

In line with what markets have seen for much of this year, Treasuries continued to trade in a range over June. A stronger-than-expected US labour report at the beginning of the month saw a sharp sell-off in rates as markets moved to reduce the probability of cuts by the Federal Reserve (Fed) this year. A non-farm payroll gain of +272k was well ahead of the +180k anticipated by the market, while a 0.4% increase in average hourly earnings printed a tenth higher than expected, pointing towards a stubbornly resilient labour market. The following week, however, saw encouraging inflation data out of the US contributing to an equally significant Treasury rally, with the downside surprise in core CPI of +0.16% (versus the +0.3% print anticipated by markets), representing the lowest monthly figure since August 2021, and the headline number coming down to 3.3% on an annual basis. Markets also received updated dot plot projections by the Fed, which showed the median dot pencilling in just one cut by year-end 2024, having signalled three cuts back in March. The FOMC, who as expected kept rates unchanged, also released an updated Summary of Economic Projections (SEP) in which their year-end 2024 core PCE inflation projection was revised up from 2.6% to 2.8%, while the 2025 predicted figure was raised one-tenth to 2.3%. An inline headline and core PCE release at the end of the month brought both year-on-year (YoY) figures down to 2.6%. On the core side, this represented the lowest annual core PCE figure since April 2021, adding to the growing evidence that US inflation is cooling.

Economic data in Europe has pointed towards a cooling inflationary environment for much of this year, a trend which enabled the European Central Bank (ECB) to cut rates by 25 basis points (bps) at the beginning of June, representing the first major central bank to begin its cutting cycle. There remains considerable debate surrounding the extent to which the ECB is willing to diverge from the US should the Fed continue to hold firm on rates, particularly as the last leg of inflation is proving to be stickier than previously anticipated in Europe. Over in the UK, the Bank of England (BoE) held rates at 5.25% as expected, with the decision split 7-2 (seven members voting to hold and the remaining two opting for a 25bps cut) and the central bank's statement revealing that "the policy decision was finely balanced" for some members. Despite this, it was the inflation print a day prior which caught the attention of markets, with YoY headline inflation falling to the BoE's target of 2% for the first time since July 2021. The details of the release were less promising, however, as services inflation remained stubbornly high at 5.7% (only a slight decrease from previous months) and materially higher than the BoE's forecast of 5.3%.

For much of June, European markets were weighed down by the political uncertainty which ensued after French President Emmanuel Macron called a snap election in response to his party's poor performance in the EU parliamentary elections. Having hovered around the 50bps mark for much of this year, the 10-year OAT-Bund spread (the difference between French and German yields) rose sharply to over 80bps following the election announcement, representing a significant surge in risk premium required on French assets given the insecurity surrounding the future political landscape in the country. The first of two election rounds, at the end of the month, however, delivered a slightly less convincing victory for Le Pen's far-right party than polls initially suggested. Ahead of the second round, the National Rally is expected to win 34% of the vote, while the left-wing NFP coalition and Macron's party are set to be at around 29% and 21%, respectively, suggesting a hung parliament is the most likely scenario at this stage.

Portfolio Commentary

With a good backdrop for rates, but lacklustre performance from credit spreads, the Fund returned +0.56% for the month, net of fees. This takes Q2 returns to +1.07%, some 25 basis points (bps) of which was alpha, and year-to-date returns to for the H1 period are at +2.48%. This is +77bps higher than the 1-5Yr Sterling Corporate Index over the same period.

All top-level sectors were in the green for the month, with government bonds for once leading the pack, and notably so. The five-year positions in German bunds and US Treasuries produced nearly identical returns, with the total

government bond allocation returning +1.24%, more than double the portfolio average. This contributed +18bps to returns, nearly one third of the total portfolio return.

The secured bond sector was next, returning +0.65%, pretty evenly split between holdings across a range of maturities. Just below this, senior non-financials and asset-backed securities (ABS) had identical returns, with both floating rate ABS and fixed rate senior non-financials returning +0.52%, with every single bond from both sectors producing good positive returns.

Corporate hybrids were next, returning +0.46%, again with every single bond in the green, and no individual stories that stood out over the month.

Financials overall produced a similar total return of +0.42%, with banks outperforming, delivering +0.49%, versus +0.29% for insurance. Unusually, there was nothing to split the returns from bank subsectors, with Additional Tier 1s (AT1s) and Tier 2s (T2's) returning +0.49% and +0.50% respectively, with seniors just behind at +0.48%. Insurance averaged +0.29%, with senior outperforming, delivering +0.40%, while both T3s and other subordinated bonds returned +0.34% and +0.28% respectively.

The Fund retains a continued lower beta stance than normal given non-financial spreads that, in the views of the portfolio managers (PMs), 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, 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, 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 sector, the PMs 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 Fund 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.

Market Outlook and Strategy

With the ECB having now delivered the first rate cut for this cycle in June, it is certainly possible that the Fed and the BoE could follow suit in Q3, albeit most likely at the tail end of the quarter. As such, the major risks to capital from duration risk have ended, and thus the PMs have become more tolerant of duration in the Fund, taking 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 the website). On the flip side, however, 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 likely to be in short-dated bonds. As such, a modestly lower-than-average duration profile is still warranted, with peak yields still being less than two 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 recession risks both remain significant, and are not fully priced into non-financial spreads, in the views of the PMs. Therefore, a lower beta credit stance is still warranted, although the prospect of further rate cuts suggests total returns from short-dated credit can still 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, make short-dated IG still a fantastic risk/return opportunity. This is predominantly due to the very high breakeven yield the portfolio now exhibits, with a yield of 5.50% and a duration of two years meaning the breakeven yield is nearly +300bps. Although the PMs fully expect some volatility to remain in markets for some months yet, a scenario where the portfolio yield rises by more than +3% to around 8.5% over the next 12 months seems very remote, and as such the probability of positive total returns over the next 12 months remains very 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 like in more detail.

Cumulative Performance	1m	3m	6m	1y	Annualised			
					3y	5y	10y	Since Inception*
Class G	0.56%	1.07%	2.48%	7.57%	1.32%	N/A	N/A	1.42%
SONIA + 250	0.63%	1.94%	3.91%	7.99%	5.52%	N/A	N/A	4.58%

Discrete Performance	YTD	2023	2022	2021	2020	2019	2018	2017	2016	2015	2014
Class G	2.48%	6.52%	-4.21%	0.24%	N/A	N/A	N/A	N/A	N/A	N/A	N/A
SONIA + 250	3.91%	7.36%	3.97%	2.59%	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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