TwentyFour
a boutique of Vontobel

Fund Commentary | 31 July 2024

Vontobel Fund – TwentyFour Absolute Return Credit Fund

This Commentary is a marketing communication for professional UK investors only

Market Commentary

July was a very strong month for fixed-income markets as cooling inflation and weakening labour market data led to a growing narrative that the cutting cycle is edging closer for the US Federal Reserve (Fed) and the Bank of England (BoE). Government bonds rallied sharply as investors moved to price in the probability of a greater number of interest-rate cuts by year-end, while heightened geopolitical tensions and political instability contributed to marginal credit spread widening. Equity markets had a more mixed month after a strong run over the year to date (YTD), with some evidence of sectoral weakness – particularly consumer discretionary.

US Treasuries experienced a steady and consistent rally throughout July as economic data pointed towards signs of weakening in both the US labour market and the consumer. The US jobs report at the beginning of the month delivered something for everyone; the non-farm payroll number came in higher than expected at +206k (versus +190k anticipated), but the last two months of revisions totalled -111k. The unemployment rate unexpectedly ticked up by another 10 basis points (bps) to 4.1%, fuelling fears that an upward unemployment rate trend is beginning to form given the increases in previous months. This was followed by a promising US inflation print, which showed month-over-month headline consumer price index (CPI) inflation falling by -0.1%, well below the +0.1% expected by markets and marking the biggest monthly decline since May 2020. The core print was equally encouraging, rising just 0.1% (versus the 0.2% survey figure); this represented the weakest month for core inflation since the beginning of 2021. The year-over-year headline and core prints fell to 3% and 3.3%, respectively, as the Fed continued its path to bringing inflation down to the 2% target. A stronger-than-anticipated second-quarter US GDP print later in the month partly pushed back on a growing narrative that the US economy was showing the first real signs of struggle. Economic growth came in at an annualised rate of 2.8% in the second quarter (compared to the expected figure of 2%), which is double the 1.4% pace seen in the first quarter. At the end of the month, the Fed acted in line with market expectations, keeping rates unchanged at its July meeting. However, Fed Chair Jerome Powell mentioned that the Federal Open Market Committee had started to discuss potential rate cuts and announced that "a reduction in the policy rate could be on the table at the September meeting".

US politics continued to dominate headlines during July as Joe Biden announced his withdrawal from the 2024 US Presidential race following weeks of pressure from members of the Democratic party. Vice President Kamala Harris took over as the Democratic presidential nominee and polls have the match-up between Trump and Harris as narrower than the Trump-Biden contest. In Europe, the second round of French elections brought an electoral shock, with the far-left New Popular Front (NPF) winning 188 seats and consequently securing the surprise outcome of being the largest single bloc. The far-right Rassemblement National (RN) party claimed 142 seats, significantly below the 190 expected before voting began, while Macron's bloc secured 161 seats – up from the 135 expected prior to the election. Since no bloc came close to an absolute majority (289 seats required), a hung parliament is the most likely scenario. The UK held its own national elections in July and will have a Labour Majority government (412 seats) in charge for the first time since 2010. Since the result was largely expected, the most noteworthy event from the election was the collapse in the Conservative vote, which went primarily to the right-wing Reform UK Party.

Eurozone CPI in July was marginally stronger than expected, with headline and core inflation rising a tenth above expectations, to 2.6% and 2.9%, respectively, on a year-over-year basis. The slight reacceleration in inflation and lack of significant weakness throughout European economies meant the European Central Bank (ECB) left base rates unchanged at its July meeting, but continued to insinuate that there will be further easing in the near future. This contrasts the narrative building in the UK, whereby investors moved to price in a 25bp rate cut ahead of the BoE's meeting on August 1 given that headline CPI remained at the targeted 2% for a second consecutive month. The UK economy also returned to growth in May as GDP rose by +0.4% on a month-over-month basis, double the +0.2% anticipated figure. Over the three months to the end of May, the economy grew by +0.9%, representing the fastest rate for over two years. Equity markets had a mixed month following a series of revenue misses and profit warnings from several big companies, particularly those in the airline, fashion and automotive industry.

Portfolio Commentary

With a good backdrop for rates and credit, the Fund returned +1.12% for the month, net of fees. This takes YTD returns to +3.70%, some +59bps higher than the 1-5 Year Sterling Corporate Index over the same YTD.

Every bond in the portfolio was up during July, even those added later in the month. Likewise, every sector had good positive returns, with even the lowest returning sector (floating-rate asset-backed securities (ABS)) still returning more than a month's worth of yield at +0.66%.

Given a good month for risk assets, slightly surprisingly, it was the government bonds in the portfolio that just edged the best returns, delivering +1.53%, contributing +23bps to total Fund returns. Half of those bonds were five-year US Treasuries, returning +1.76%, with the German five-year bund position returning +1.19%. Without credit spread tightening to help returns, it was the higher duration five-year nature of these bonds that added value, which have been consistently added to the Fund since February this year.

The insurance sector was next best, returning +1.36%, contributing +19bps, with quite similar returns between the Subordinated and Tier 3 subsectors. Banks returned +1.21%, contributing +35bps, with Tier 2 bonds outperforming Seniors and Additional Tier 1s (AT1s) returning +1.25% versus +1.20% and +1.07%, respectively. This means financials, overall, returned +1.25% - a total portfolio contribution of +54bps.

Corporate hybrids had a solid month, returning +1.11% - a contribution of +12bps. EDP and Southern Co were notable outperformers returning more than 2% each. Senior investment grade (IG) corporate bonds returned +0.76%, with many individual bonds edging over 1% return, typically with maturity dates in 2027 or 2028.

Secured bonds returned exactly 1%, but a small contribution of +4bps, given an average weighting of less than 5%; it was a good return, nonetheless.

The Fund retains a continued lower beta stance than normal given non-financial spreads, which, in the portfolio managers' (PMs') views, are starting to look too tight for economic risks that 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 sector 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.

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 the third quarter (most likely at the tail end of the quarter for the Fed). As such, the major risks to capital from duration risk have ended. Therefore, the PMs have 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 the 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 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 portfolio is focusing. However, as duration risks start receding, the PMs are concerned that increasing unemployment rates across the US, the UK and especially Germany signal worsening GDP data to come. 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 still warranted, although the prospect of further rate cuts suggests total returns from short-dated credit can remain attractive for some time yet.

In summary, we believe the combination of low duration and high average yield, with high average credit quality, makes 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 5.28% and a duration of two years meaning the breakeven yield is nearly +270bps. Although the PMs fully expect some volatility to remain in market for some months yet, a scenario where the portfolio yield rises by more than +2.7% to 8% over the next 12 months seems very remote. As such, the probability of positive total returns over the next 12 months remains very 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	5y	10y	Since Inception*
Class G Acc	1.12%	2.33%	3.17%	7.89%	1.30%	1.75%	N/A	2.52%
SONIA + 250	0.66%	1.96%	3.91%	8.01%	5.68%	4.52%	N/A	3.84%

Discrete Performance	YTD	2023	2022	2021	2020	2019	2018	2017	2016	2015	2014
Class G Acc	3.70%	6.08%	-4.80%	0.52%	2.47%	5.02%	-0.83%	5.25%	4.99%	N/A	N/A
SONIA + 250	4.59%	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. 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.

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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