TwentyFour
a boutique of Vontobel

Fund Commentary | 31 December 2024

# Vontobel Fund – TwentyFour Absolute Return Credit Fund

**This Commentary is a marketing communication for professional UK investors only**

## Market Commentary

Hawkish central bank meetings and the renewed risk of inflation in the US economy drove a significant sell-off in fixed income markets in December. Increasing caution over the pace of rate-cutting cycles across major economies pushed the 10-year Treasury yield up by 38 basis points (bps) during the month. The rise came as investors lowered their expectations for extensive interest rate cuts by the Federal Reserve (Fed) and other central banks in 2025. Equity markets also reacted negatively, with the 'higher-for-longer' interest rate narrative gaining traction.

Following November's somewhat unreliable US labour report, given weather-related disruptions to employment, the market paid particularly close attention to December's numbers. The mixed jobs report saw the headline non-farm payroll figure rise by 227,000 month-on-month, which was broadly in line with the consensus number of a 220,000 increase. However, the unemployment rate ticked up to 4.2%, which represented a significant upside surprise relative to the 4.1% expected by economists. The 10-year Treasury yield, which bottomed out at 4.13% in the immediate aftermath of December's labour report release, spent the rest of the month on the rise as a slew of economic data led investors to reduce the probability of significant interest rate cuts by the Fed in 2025. The most significant of these data releases was for US inflation. The monthly headline and core Consumer Price Index (CPI) readings both came in at 0.3%, which took the year-on-year numbers to 2.7% and 3.3%, respectively. Although these figures were broadly in line with expectations, longer-term inflation trends were of concern to investors as the three-month annualised pace of core CPI ticked up again to 3.7%. The headline Producer Price Index print was stronger than expected, with the year-on-year rate edging up to 3.0% for the first time since the beginning of 2023, as did the US retail sales release prior to the Fed meeting. The Fed's meeting in the middle of the month compounded the growing narrative that it would pursue a more hawkish approach next year than previously anticipated. An expected 25bps cut (which took the Fed funds rate down to 4.25-4.50%) was accompanied by an updated set of 'dot-plot' projections showing just 50bps of cuts for 2025, down from 100bps previously. Furthermore, the long-run median dot shifted up to 3.0%, while inflation projections were increased significantly, with personal consumption expenditures (PCE) inflation now predicted to be 2.5% by the end of 2025, up from 2.1% previously. Fed Chairman Jerome Powell highlighted that the Federal Open Market Committee members would need to see more "progress on inflation" in order to cut rates further as risks to inflation tilted to the upside. Towards the end of the month, it emerged that the core PCE price index rose by 0.1% month-on-month in November, versus a consensus estimate of a 0.2% increase, which helped to partially reverse some of the negative sentiment around re-accelerating inflation.

Similarly to the Fed, the European Central Bank (ECB) adopted a more hawkish approach than many had expected at its meeting, despite delivering its own 25bps rate cut to take the deposit rate down to 3.0%. Updated forecasts saw both economic growth and inflation projections downgraded over the years ahead, with GDP growth at just 1.1% (down by 0.2 percentage points from the previous quarter) and headline CPI at 2.1% (down from 2.2%) by the end of 2025. However, ECB President Christine Lagarde made some surprising comments, including that eurozone inflation risks were still "two-sided", which cast doubt over how aggressively the ECB would reduce rates in 2025. Many of the same economic data trends persisted in the eurozone, with weaker growth and slowing inflation continuing. There was political turmoil in France, however, as Marine Le Pen's party, backed by left-wing parties, announced that it would support a no-confidence motion in the government of Prime Minister Michel Barnier. Barnier went on to lose the vote, with the National Assembly choosing to oust his government, with 331 votes in favour out of 577. The result was somewhat expected and markets did not move much. Emmanuel Macron confirmed his intention to remain as president for the remainder of his term, which runs out in 2027.

The Bank of England (BoE) bucked the trend in its meeting, striking a more dovish tone than anticipated. The decision to hold rates at 4.75% was widely expected, but this outcome was only made by a 6-3 vote, with the minority opting for a 25bps cut. The BoE's statement pointed towards further easing in the near future as a "gradual approach to removing monetary policy restraint remained appropriate". Tracking US Treasury moves, UK gilts remained under pressure throughout the month, however. The CPI print did little to help matters, with December's reading showing that headline inflation accelerated to an eight-month high of 2.6% and that core inflation ticked up again to 3.5%. The final number for third-quarter GDP came in a tenth below expectations at 0%, which, when combined with the aforementioned inflation picture, led to growing concerns that the country was potentially heading towards a stagflationary environment.

## Portfolio Commentary

Despite a tough month for government bonds globally, credit performed well and the Fund returned +0.20% after fees, rounding out the fourth quarter with a return of +0.85%.

For the 2024 calendar year, the Fund returned +5.87%, some 85 basis points (bps) higher than the sterling 1-5-year investment-grade (IG) credit index return of +5.02%, and some +333bps higher than the FTSE gilts up to five-year index return of +2.54%.

The full-year attribution shows a narrative of narrowing credit spreads and increased carry from higher beta credit sectors. This more than offset the capital losses from rises in government bond yields during 2024, a year when rate-cut expectations were significantly dialled down in the face of stronger-than-predicted inflation, especially core inflation. Breakeven yields and breakeven spreads therefore were very strong predictors of return for the year – a theme the portfolio managers (PMs) believe will continue in 2025.

As such, contingent convertible (CoCo) bonds were the strongest performers for the Fund, returning +9.37% (contributing +29bps). Notably, the majority of the positions were in bonds that were so short dated that they matured or were called in 2024 and were replaced with similarly short-dated positions that have call dates predominantly in 2025.

Likewise, with high starting yields and very near-term call dates, corporate hybrids had a very strong return of +7.44% and a contribution of +81bps. The bulk of the portfolio's exposure was on short-dated utility and telecommunication hybrid bonds that consistently pulled to par throughout the year.

Floating-rate asset-backed security positions also had a strong year, returning +7.32% with a contribution of +41bps. The higher-for-longer narrative on short-term rates resulted in continued good performance from the asset class.

Both insurance and banks had similar returns overall, delivering +6.94% (+100bps contribution) and 6.85% (+197bps contribution), respectively, although the differences between the two were greater than the headlines suggest. CoCos led, as mentioned earlier, while Lower Tier 2 subordinated banks returned +7.88% (contributing +79bps) and Senior banks returned closer to the portfolio average of +5.63% (contributing +89bps). Within insurance, there was little difference between the subsectors, with subordinated returning +6.88% (+93bps contribution) versus Tier 3's +6.85%.

Senior non-financials, which had the lowest breakevens at the beginning of the year, had the weakest return of the portfolio's credit exposure, returning +5.06%. This was more or less in line with the benchmark return of +5.02%. There were no nasty surprises, although the lower carry clearly did not deliver similar results to the higher breakeven and carry sectors mentioned above.

The Fund retains a lower beta credit stance than normal, given non-financial spreads that, in the PMs' view, look very tight versus long-term history while all-in credit yields remain attractive. This lower beta stance is predicated on mark-to-market risks from wider spreads, rather than default risk per se. That said, the portfolio retains several higher beta credit positions in subordinated financials and corporate hybrids. However, the maturity profiles of these positions are deliberately very near term to both maximise carry and simultaneously keep spread duration low. As such, the portfolio's overall credit spread duration remains historically low at 1.4 years while total or interest-rate duration is two years, which is much closer to historical norms.

## Market Outlook and Strategy

With the ECB having delivered its fourth interest rate cut, and the Fed dropping rates three times, the prospect of further reductions looks modest through 2025. The major risks to capital from duration risk have ended, and thus the PMs have continued to become more tolerant of duration in the Fund, taking interest-rate duration up to two 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 slight yield-curve inversion and tight credit spreads in some sectors still give the PMs concerns about adding credit spread duration into the Fund at present, with the biggest capital gains likely to be in short-dated bonds. A modestly lower-than-average duration profile remains warranted, with peak yields still being shorter-dated securities, which is where the portfolio is predominantly focused. 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. Recession risks remain significant and are not fully priced into non-financial spreads, in the PMs' view. Therefore, a lower beta credit stance remains warranted, although the prospect of modest 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, 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 5.38% and a duration of two years, which means the breakeven yield is +269bps. Although the PMs expect some volatility to remain in the market for some months yet, a scenario where the portfolio yield rises by more than about +2.7% to about +8% over the next 12 months seems very remote. As such, the probability of good positive total returns over the next 12 months remains very high.

| Cumulative Performance | 1m | 3m | 6m | 1y | Annualised | | | |
|---|---|---|---|---|---|---|---|---|
| | | | | | 3y | 5y | 10y | Since Inception* |
| Class G Acc | 0.20% | 0.85% | 3.23% | 5.87% | 2.25% | 1.95% | N/A | 2.63% |
| SONIA + 250 | 0.61% | 1.86% | 3.81% | 7.87% | 6.39% | 4.88% | N/A | 4.01% |

| Discrete Performance | 2024 | 2023 | 2022 | 2021 | 2020 | 2019 | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Class G Acc | 5.87% | 6.08% | -4.80% | 0.52% | 2.47% | 5.02% | -0.83% | 5.25% | 4.99% | N/A | N/A |
| SONIA + 250 | 7.87% | 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

## Fund Managers

**Chris Bowie**
Partner, Portfolio Management, industry experience since 1992.

**Gordon Shannon**
Partner, Portfolio Management, industry experience since 2007.

**Jack Daley**
Portfolio Management, industry experience since 2011.

**Johnathan Owen**
Portfolio Management, industry experience since 2018.

Further Information and Literature:
TwentyFour Asset Management LLP

T. 020 7015 8900
E. sales@twentyfouram.com
W. twentyfouram.com

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**