LOMBARD ODIER
INVESTMENT MANAGERS

LO Funds
High Yield 2024
Newsletter IM - Professional

Global Fixed Income • Fixed Income

31 July 2024

PERFORMANCE

30.06.2024	INCEPTION	AUM	QUARTER-TO-DATE	YEAR-TO-DATE	INCEPTION-TO-DATE	2023	2022	2021
LO Funds – High Yield 2024, (EUR) PA	17 February 2020	EUR 78 mn	2.64%	2.64%	2.59%	7.82%	-10.21%	1.96%
LO Funds – High Yield 2024, (EUR) MA			2.82%	2.82%	4.21%	8.21%	-9.88%	2.33%
LO Funds – High Yield 2024, (EUR) NA			2.89%	2.89%	4.81%	8.35%	-9.77%	2.46%
LO Funds – High Yield 2024, (CHF) PA			1.39%	1.39%	-1.75%	5.61%	-10.87%	1.74%
LO Funds – High Yield 2024, (CHF) MA			1.57%	1.57%	-0.20%	5.99%	-10.55%	2.11%
LO Funds – High Yield 2024, (CHF) NA			1.64%	1.64%	0.37%	6.13%	-10.43%	2.24%
LO Funds – High Yield 2024, (USD) PA			3.39%	3.39%	10.35%	9.96%	-8.11%	2.82%
LO Funds – High Yield 2024, (USD) MA			3.57%	3.57%	12.10%	10.36%	-7.78%	3.20%
LO Funds – High Yield 2024, (USD) NA			3.64%	3.64%	12.74%	10.50%	-7.66%	3.33%

Past performance is not a guarantee of future results. Performance is presented net of fees.

MARKET REVIEW

As we pass the midpoint of the year, two key themes have emerged that have important implications for fixed income. The first is the growing divergence in economic conditions between regions, which is increasingly reflected in differing monetary policy approaches from central banks. The second is that in a year when more voters than ever in history are going to the polls, political risk is making its presence felt.

With economic conditions now clearly varying between regions, developed market central banks are plotting their own routes forward, searching for suitable terrain to create the soft-landing markets are hoping for.

In Europe, while economies have recovered post-pandemic, the region is still not back to trend growth. With inflation relatively low (albeit going through similar upswings and downswings as other economies globally) and growth lagging, the European Central Bank felt confident at the beginning of the year to tie its colours to the mast regarding rate cuts. However, a reacceleration – among other factors, with lower inflation potentially creating more disposable income and better demand – has prompted the ECB to make a hawkish rate cut while refusing to commit to future actions.

The Fed, meanwhile, has been dealing with a more volatile and complex situation. Unlike in Europe, economic slack is almost non-existent in the US. Nominal growth is back to pre-pandemic levels, while other data has given mixed indications. This has left open the possibility that inflation continues to run hot, making it difficult to navigate a path and creating the risk that any action from the central bank will do more harm than good. The Fed has therefore adopted a “wait and see” approach, while telegraphing that rate cuts will come in time.

With the Fed at peak restrictive policy, the US case is trickier to handle, particularly when political uncertainty is added to the mix. In our view, though, the US economy is showing quite clear signs of slowing down. Meanwhile, the fiscal deficit is high, but market participants are buying US debt, and the steepening of the curve has been somewhat limited. All things being equal, we foresee up to two rate cuts in the US before the end of the year, with a subsequent steepening of the curve as the front end moves lower.

The uncertainty created by rising support for populism and a snap election in France has so far been reasonably contained; however, political risk is a feature both in Europe and the US given candidates’ unorthodox policies.

In the US, the result of the presidential elections in November could have significant implications for the country’s economy, and the Fed must stand ready to adapt. The impact of another Trump presidency may be strongly inflationary given his stated policy intentions in areas such as trade and immigration, especially in a still-tight labour market. Consequences could include accelerating growth, demand-side inflation due to stimulation, or an impact from tariffs on the supply side.

Similarly, in Europe, increasing political polarisation and a rise in populism potentially sets the scene for a more profligate approach to governance. The European election results and snap general election in France have led to quite a significant repricing of what are usually seen as reasonably safe assets in the regional context. While the country's high debt is not a major risk in itself, the potential for a party to come into power with plans for major spending is causing concern.

From a risk perspective, the current environment remains fairly benign, with broadly robust growth and easing inflation creating reasonable expectations of a soft landing. That said, the situation has yet to tip decisively in one direction or the other; it should be kept in mind that softening is rarely linear and can become disorderly, while the nature of any hard landing is that it is not apparent until the impact arrives. Overall, though, it's hard to see the economic backdrop shifting dramatically in the short term unless a major shock materialises.

Against this resilient backdrop, fixed income investors had to endure another quarter of negative returns for global investment-grade bonds. More broadly, the benign macro environment supported the riskier segments of fixed income. Resilient economic activity in the second quarter fed through into resilient corporate earnings, which kept both default rates and spreads contained. European high yield and US high yield were the top-performing fixed income sectors. Both delivered positive total returns over the quarter, supported by strong coupon payments and the ancillary benefit of lower sensitivity to the moderately higher sovereign yields in Europe and the UK.

PERFORMANCE AND PORTFOLIO ACTIVITY

In this environment, the Fund delivered a positive Q2 2024 total return for all of its share classes: USD +1.69%, EUR +1.30%, and CHF +0.62% [1].

Portfolio activity was driven in part by reinvesting the proceeds from bonds that matured or were called. We also decided to reduce our exposure to bonds with maturities longer than the maturity of the Fund by reinvesting into shorter-dated bonds that offered higher yields. This was made possible by the inversion of the overall interest-rate curve. When selecting bonds to purchase, we always focus on two criteria in particular: bonds that match the Fund's maturity and that maintain or improve the Fund's risk/return profile. There was no activity in our Credit Default Swap (CDS) holdings, and the Fund's leverage remains at about 49%.

Based on the performance since inception and its yield to worst (net of fees) as of 29 June 2024, and assuming no future realised losses on any current position, we estimate the Fund to deliver an expected annualised total return at maturity of about 3.4%, 1.6% and 0.5% for USD, EUR and CHF share classes, respectively. These are indicative figures and are subject to future market developments.

The average rating for the Fund's bond investments remains stable, firmly in the BBB- [2] range. Around 81% [2] of the instruments are rated in the BB range or above, as we are defensively positioned from a default/risk standpoint in the current environment.

OUTLOOK

As the Fund approaches its final maturity, its activity will focus on selling the remaining bonds that will not be called or redeemed by then, which currently represent just under 19% of the portfolio's market value. However, most of these bonds have their maturity date close to the Fund's maturity and are trading near par; therefore, this activity should have a limited impact in terms of performance. We will also continue to monitor the default risk and credit quality within the portfolio rigorously to avoid any negative outcomes as the Fund approaches its conclusion. Finally, the current yield to worst of the Fund and its defensive positioning offer attractive prospects, which should support further positive absolute performance towards its maturity.

[1] All NA share classes. Performances are net of fees.

[2] Calculated as of 29 June 2024, using the second-best rating per instrument. Where an instrument is unrated, an internal rating is assigned. All ratings refer to the instrument rating.

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