LOMBARD ODIER
INVESTMENT MANAGERS

# LO Funds
# Fallen Angels Recovery
## Newsletter

Global Fixed Income • Fixed Income

31 October 2024

## FIXED INCOME MARKET OVERVIEW

October saw Fixed income post its first negative performance at an aggregate level since April, as macro uncertainty pushed rates into a sell-off. The duration component dragged down the broad fixed income complex, but credit spreads tightened, bringing some welcome diversification to slightly dampen aggregate volatility. Being in the epicenter of election news flow, US was the underperformer, whilst from a sector perspective, Autos were slight outperformers as they reversed some of their underperformance of September.October felt like a month where more weight was put on fiscal policy developments rather than monetary, with a number of political events coming under the spotlight. The one prominent central bank meeting came from the ECB who expectedly delivered a third 25bps cut of the cycle, but President Lagarde continued to underline a focus on returning inflation to target, despite growth trending lower and inflation below target by shorter term measures in some regions. That said, growth and CPI did surprise to the upside in Germany to end the month, seeing the bloc's largest economy avoid a recession.The key focal point, particularly towards month-end was of course the impeding US presidential election. Odds shifted back towards a Trump victory, largely driven by a surge in support for the Republican candidate in betting markets, with national polls also moving in that direction. This saw US rates push higher, with a red sweep of both the house and the senate perceived to be the problematic outcome for US duration, as prolonged and elevated fiscal deficits are expected to temper rate cuts in 2025 and possibly increase terminal rates.Rate sentiment was also buffeted by the Labour party's first budget in the UK, with the now infamous budget of Liz Truss in 2022 still fresh in the memory. Whilst a very different type of budget, UK rates whipsawed around the recalibration of policy in the UK, as markets digested a mix of higher taxes, spending and borrowing. Ultimately UK rates sold off in quite some size, but certainly not to the degree of 2022 that threatened financial stability.Whilst rhetoric from the US and UK budget jitters seemed to drive negative rates sentiment later in the month, the fiscal events had actually begun early in the month with France's budget announcement. This was really the start of rates poor performance, with the nation forecasting higher borrowing and deficits in coming years, seeing term premia increase substantially across Eurozone nations. Elsewhere, a lack of clarity on the commitment to prolonged and targeted stimulus saw the China risk rally reverse somewhat, however still substantially up from the lows of September. Tensions in the middle east between Israel, Iran and its proxies continue to be volatile but currently any escalation gets reversed quickly as retaliatory responses point towards two parties uninterested in direct conflict. On margin, the repricing in rates has made government bonds more appealing, but with substantial event risk in the US election we prefer to access duration via investment grade and high-quality high yield, where added credit exposure offers the chance for diversification to support total returns. That said, once the election outcome is decided, we'd expect volatility to subside and the immediate reaction to the result could offer entry opportunities, so nimble active management of portfolios remains key.

## PORTFOLIO ACTIVITY

October saw no new Fallen Angels and one issuer leaving the universe.Service Properties Trust (SVC) bonds were cut to Caa1 with a negative outlook by Moody's in October. The downgrade reflected the hotel REIT's weak operating performance and deteriorating cash flow and resulting very high leverage and weak fixed charge cover. In addition, there is very limited headroom in its bond and Revolving Credit Facility (RCF) covenants which could limit the company's ability to incur more debt and therefore refinance near term debt maturities. We exited SVC early in 2023 on concerns around governance, inconsistent financial policy and business strategy which meant we were not convinced they would be able to refinance near term debt maturities.

## PERFORMANCE AND CHARACTERISTICS

. The fallen angel strategy is a high quality high yield strategy with an average rating of BB+; some two notches better than the high yield index.. The strategy out-performed both the high yield and Fallen Angel indices in October. Out-performance came from our security selection within the utilities and Retail & Consumer sectors. UK water company Thames recovered somewhat after being downgraded to CCC the previous month. In the retail space Newell Brands bonds benefitted from the positive momentum from successfully issuing USD1.25bn of new notes which was sufficient to refinance its 2025 and some of its 2026 maturities. Department stores Macy's and Nordstrom recovered from the negative price action in the previous month as investor attention perhaps switched from the short-term benefits of being taken private to considering the longer term impact of successfully turning around the businesses - something we believe is occurring.. Year to date performance lags that of the high yield index but remains materially ahead of the Fallen Angel index which has underperformed the high yield index by close to 300bp this year reflecting the structural differences between the two indices. This performance supports our view of the critical importance of active management and alpha generation within this strategy. . Outlook: The recovery in the real estate since the end of last year continues albeit at a slower pace. We still expect this sector to provide a number of new Fallen Angels as while interest rates have peaked which will stabilise valuations, refinancing costs ae still high and interest cover - a key credit metric - will weaken. We are now starting to see some weakness within the consumer cyclical sectors along with the automotive industry where a number of profit warnings have led to some negative rating actions albeit no new fallen angels. Finally, the UK water sector remains under pressure and we could see some more players joining Thames in the High yield space in the next six months or so.

## PERFORMANCE

| 30.10.2024 | INCEPTION | AUM | MONTH-TO-DATE | YEAR-TO-DATE | INCEPTION-TO-DATE | 5 Year Ann. Return | 10 Year Ann. Return |
|---|---|---|---|---|---|---|---|
| LO Funds - Fallen Angels Recovery, Syst. Multi Ccy Hdg, (USD) NA | 30.11.2021 | USD 387 mn | -0.06% | 6.19% | 7.69% | | |
| Bloomberg Barclays Global High Yield Corporate ex-EM TR HDG USD | | | -0.22% | 7.70% | 10.66% | | |

Past performance is not a guarantee of future results. Performance is presented net of fees. AUM as of the date of the table.

## RISK AND REWARD PROFILE

| 1 | 2 | **3** | 4 | 5 | 6 | 7 |
|---|---|---|---|---|---|---|

Lower Risk — Higher Risk

The following risks may be materially relevant but may not always be adequately captured by the synthetic risk indicator and may cause additional loss:
**Credit risk:** A significant level of investment in debt securities or risky securities implies that the risk of, or actual, default may have a material impact on performance. The likelihood of this depends on the credit-worthiness of the issuers.
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Before taking any investment decision, please read the latest version of the prospectus, the articles of incorporation, the Key Information Documents (KIDs) and the latest annual report and semi-annual report. Please pay attention to the Appendix B "Risk Factors Annex" of the prospectus.

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