LOMBARD ODIER
INVESTMENT MANAGERS

LO Funds
Fallen Angels Recovery
Newsletter

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OVERVIEW OF THE FIXED INCOME MARKET

After a sharp risk off drawdown to begin the month, fixed income recovered markedly to record a second successive month of strong performance in August. Return drivers varied across geographies, with high yield outperforming in Europe, whereas US saw more upside from duration, albeit also alongside compressing spreads. However this differential between regions was actually driven by EUR HY real estate, which saw massive outperformance. Outside of this, performance across regions in the credit space was more comparable.

Markets were violently jolted at the start of the month as a brutal carry unwind saw risk on carry positive positions upended. The exact trigger is debatable but the sell off was initially started following the Bank of Japan's hawkish rate hike, and then sent into overdrive by a very weak US labour market report. The latter saw a sharp increase in pricing of the speed and magnitude of the impending cutting cycle by the Federal Reserve, at one point pricing as much as 75bps of cuts by the September meeting, including an emergency cut. The sharp move rocked the popular USD vs JPY carry trade, spilling over into wider carry positive trades as unwinding accelerated. A natural loser of the carry unwind was short volatility positions, exemplified by the VIX which suffered a record intraday increase.

However, this carry unwind induced risk off episode was ultimately extremely short lived, with risk assets reversing intraday around a stronger than expected ISM services report, which reintroduced some perspective that the US economy wasn't dropping off of a cliff edge. This ultimately began a reversal in risk markets which was almost as swift as the initial shock. Credit spreads recovered entirely within a matter of days and continued to cyclical tights. Rates however largely held their gains despite some repricing of very front-end expectations after the overshoot. The diversifying nature of rates against credit was a welcome reminder to focus on the macro picture through such nature and that with growth now more in focus than inflation, duration has the potential to once again play an important role in portfolios as cuts progress.

On the macro picture, it was ultimately a continuation again of the recent trend, inflation continues to lose steam and return to target levels led by goods disinflation, but also slowing services. On the other hand, growth is trending lower but remaining robust, whilst labour markets are correcting to more natural levels. The triggering of the Sahm rule in the US labour market was a key focus of concern for recession signaling, but in reality, the move higher in the unemployment rate has come from increased labour supply rate than layoffs. Whilst this trend continues, marginally higher unemployment cannot be taken as an imminent recession signal.

This broad picture was affirmed by Fed chair Powell when speaking on the back of the Jackson Hole summit, confirming that he now sees it as time to lower rates, and that the speed and magnitude will spend on incoming data. His clear emphasis on the labour market now being the number one priority for the Federal reserve marks a clear shift in focus and should mean inflation data can take somewhat of a backseat in coming months, assuming no sudden sharp exogenous shock.

PORTFOLIO ACTIVITY

There were no new Fallen Angels in August and just three bond issues left the universe:

Cruise-line, Carnival, was rated for the first time by Fitch assigning a BB long-term issuer default rating and a BBB- rating to the secured notes. This meant that the secured CCL 7 7/8 06/01/2027 bond now has two investment grade ratings (BBB- at S&P) and one high yield rating (Ba1 at Moody's) and therefore leaves the universe. It is a small issue with just USD192m outstanding. We continue to see value in the unsecured notes which we expect to return to investment grade over the next few years given the strength in demand for cruise holidays and improving financial metrics.

Two Commerzbank subordinated T2 bonds were also upgraded to IG by both S&P and Moody's on a combination of stronger profitability, enhanced domestic position and improved diversification.

While only one new issuer joined the Fallen Angel index in July, it was an important one. Thames Water is now one of the larger issuers in the Fallen Angel universe with its weight capped at 3% by market value.

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 under-performed the high yield index in August while performing more in line with the Fallen Angel index. Our exposure to the retail sector through US department stores Macy's & Nordstrom, pharmacist Walgreen-Boots & French supermarket Auchan continued to drag on performance although this was mostly off-set by a very strong positive contribution from two new fallen angels; water utility Thames and property company CPI Property which we bought in July & June respectively. Long-term real estate holding Aroundtown also contributed positively.

Year to date performance is below the high yield index on a gross basis following this month's under-performance, while the Fallen Angel index has underperformed the high yield index by close to 200bp this year. The fund's strong performance relative to the Fallen Angels index supports our view of the critical importance of active management and alpha generation within this strategy.

Outlook: The strength of the recovery in real estate since the end of last year has been something of a surprise. However, we still expect this sector to provide a number of new Fallen Angels this year as higher interest rates continue to impact valuations and financial metrics. We also continue to expect the impact of higher interest rates & lower disposable incomes to impact adversely on companies' credit quality, particularly those in the consumer cyclical sectors (automotive, leisure excluding cruise-lines, airlines etc). In the UK, we note the increasing pressure on water utilities and may see some new Fallen Angels form this sector in addition to Thames over the next 6-12 months. However, it feels currently as though new Fallen Angels are not concentrated within specific sectors but driven by company specific actions or challenges which makes fundamental analysis prior to investment in new Fallen Angels even more critical.

OUTLOOK

The events of the month reinforced rather than questioned our stance on fixed income, with a preference for duration remaining intact. We acknowledge increasing risks from diverging monetary policy backdrop and increased political uncertainty, but also take comfort in the swift recovery in credit markets following the carry unwind, underlining the appetite for credit remains strong and real money participants have sufficient cash to deploy to take advantage of buying opportunities. We remain focused on core fundamental trends, which as of now show slowing, but not collapsing demand, with earnings continuing to come in robust, albeit at slower growth rates the previous quarters.

PERFORMANCE

30.08.2024	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 386 mn	1.26%	5.24%	6.73%		
Bloomberg Barclays Global High Yield Corporate ex-EM TR HDG USD			1.58%	6.37%	9.29%		

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.

Liquidity risk: Where a significant level of investment is made in financial instruments that may under certain circumstances have a relatively low level of liquidity, there is a material risk that the fund will not be able to transact at advantageous times or prices. This could reduce the fund's returns.

Concentration risk: To the extent that the fund's investments are concentrated in a particular country, market, industry, sector or asset class, the fund may be susceptible to loss due to adverse occurrences affecting that country, market, industry, sector or asset class.

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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Access to documents in country of registrations:
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