LOMBARD ODIER
INVESTMENT MANAGERS

LO Funds
Fallen Angels Recovery
Newsletter

Global Fixed Income • Fixed Income

29 February 2024

FIXED INCOME MARKET OVERVIEW

February was another month of mixed performance in fixed income, with the pattern seen in the second half of January continuing as credit outperformed rates. This was driven by a repricing in rate expectations, as the timeframe for rate cuts was pushed back to H2, reducing the number of cuts expected in the process. Despite rates rising, this was largely inflation expectation driven rather than real rates, allowing spreads to tighten further in high yield and provide respite for total returns. Across sectors, EUR real estate was again the standout performer, but more focused within the IG rated names as January's rally in lower quality names fizzled out.

From a macro point of view, it was more of the same for the month. Inflation data remained on a downtrend in general, but disinflation to the 2% target remains some way off. In fact, certain measures, namely core services ex housing in the US, are showing tentative signs of reacceleration. Nevertheless, the path lower was always expected to be bumpy and it is important not to read too much into a single month reading and take a smoothed trend. For now, that still points towards continued disinflation, particularly in Europe, but the signs of reacceleration could threaten to derail the cuts penciled in for H2, so requires vigilance.

The growth picture continues to be divergent in a robust US versus a stuttering Eurozone. That said, some consumption focussed data prints such as retail sales and durable goods orders in the US did come out on the weaker side of expectations in a sign that perhaps the consumer is finally beginning to run out of steam. We continue to expect a reduction in consumer activity through the year, but provided it remains controlled risks of a wider recession and a breaking of the labour market will remain unlikely.

The continuation of trends ultimately led to central banks sticking to their ongoing narrative of cuts starting in the second half of the year. This is in line with the Fed’s dot plot in December, and markets moving to price as many as 7 to 8 cuts for this year was excessive. Reiteration of this schedule by central bank speakers saw markets align cut pricing to the Fed’s expectations of 3 cuts this year. Despite the weaker growth picture, a similar trajectory is priced for the ECB. We continue to see more space for ECB easing this year vs US counterparts, but reluctance to move ahead of the Fed may well see the ECB wait longer than needed.

Despite the multitude of ongoing global conflicts and the escalation in January following US led drone strikes in Yemen, geopolitics largely took a back seat in February as tensions stalled. It would appear as though there is currently very little appetite for severe escalation by major players in these conflicts, which is likely to see them continue as a threat to sentiment, but the actual likelihood of a tail event remains well contained. How these issues interact with the multitude of elections is possibly a more important narrative for markets, so is an area we are monitoring.

With little change in the overall fixed income landscape, we remain comfortable in our view of remaining invested in a barbell of high-quality high yield to access carry complemented by duration to support provide support in the event of the growth outlook fading. Despite tight spreads, we still find the all-in yield proposition of high yield appealing enough within fixed income and against equities, so remain happy to maintain exposure.

PORTFOLIO ACTIVITY

There was one new addition to the Fallen Angel universe in February.

US-based New York Community Bancorp (NYCB), the parent of Flagstar Bank (FBC), is one of the largest regional banks in the US with USD116bn of assets. The bank operates in multi-family lending, mortgage origination & servicing and warehouse lending. In 2022, NYCB acquired several assets and liabilities from Signature Bank, bringing the overall bank above 100bn in balance sheet size. This triggered a regulatory change, and the bank is now subject to enhanced prudential standards, i.e. risk based and leverage based capital requirements along with liquidity standards and stress testing. In order to comply with these requirements the bank significantly cut the dividend from 17cts to 5cts (shares plunged by 40% on the day) and increased ACL (Allowance for Credit Losses) provisioning (from USD62m in Q3 to USD552m in Q4).

This led to a few rating changes and the subordinated bonds of FBC were cut to Ba2 Negative watch and entered the Fallen Angels index. Given the high uncertainty with regards to the situation as well as the poor liquidity of the bonds with a small issue size of just USD150m, we decided not to invest in the bonds. A few days later NYCB issued a statement to delay its 10-K reporting as they discovered “material weakness” in how it tracks loans. As a result and shortly after FBC entered the Fallen Angel index the bonds were downgraded a further four notches by Moody’s to B3 Negative Watch. We continue to avoid the bonds.

Troubled French infrastructure company Atos exited the index as its credit rating was cut to CCC by S&P on concerns around the company’s ability to refinance its debt. We believe Atos is likely to enter some form of restructuring arrangement and have been reducing our exposure since the summer (see previous newletter).

Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance.

PERFORMANCE AND CHARACTERISTICS

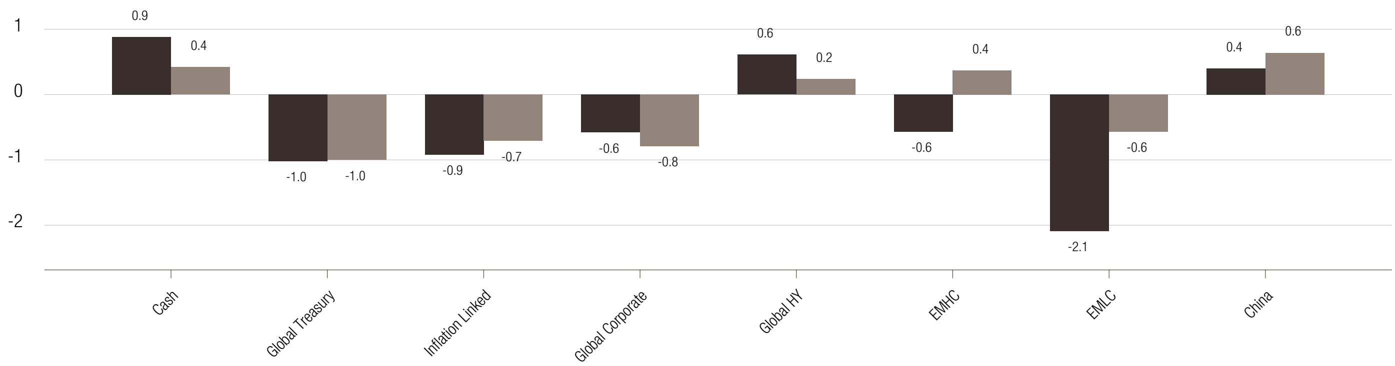
• The fallen angel strategy is a high quality high yield strategy with an average rating of BB+; some two notches better than the high yield index.

• The strategy materially out-performed the fallen angel index in February driven primarily by security selection within the TMT sector where our underweight to Atos and positions in Telecom Italia and Eutelsat contributed positively. However, this was not sufficient to offset the under-performance of the Fallen Angel index compared to the high yield index in the month.

• Year to date performance is a similar story where our active management and alpha generation has been sufficient to mitigate just over half of the performance difference between the two indices.

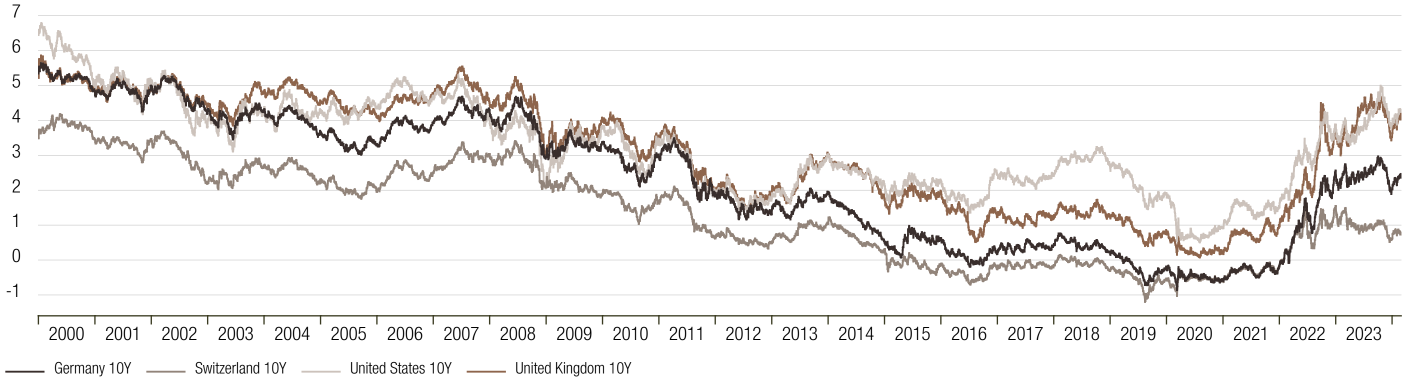
• Outlook: The strength of the recovery in real estate in December and particularly January was something of a surprise and we were not surprised to see some softness in the sector in February. However, we still expect this sector to provide a number of new Fallen Angels this year as higher interest 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 cruiselines, airlines etc).

FIG 1. Performance of Fixed Income asset classes (Hedged in USD)



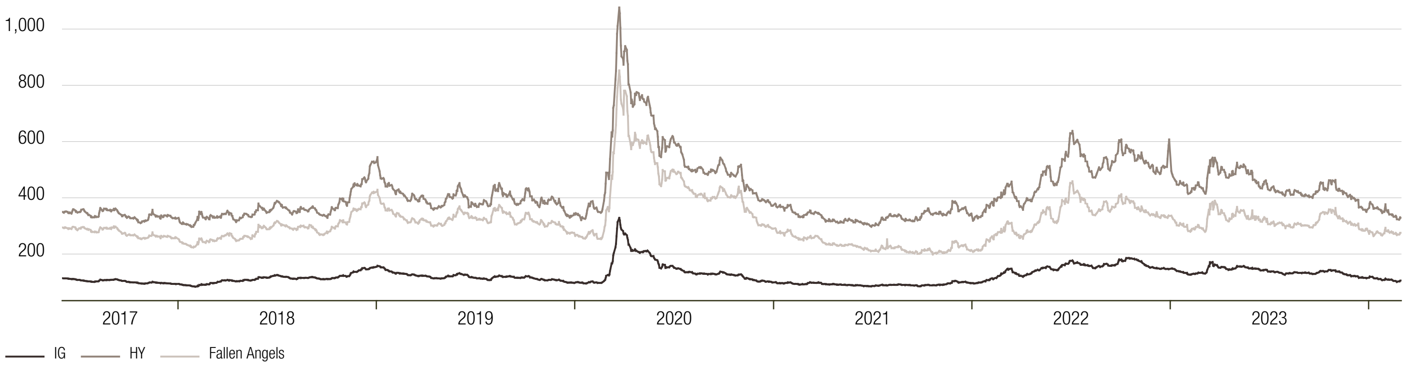
Source. LOIM, Bloomberg. For illustrative purpose only. Past performance is not a guarantee of future results.

FIG 2. Historical 10 years treasury yields (%) - 2000-2024



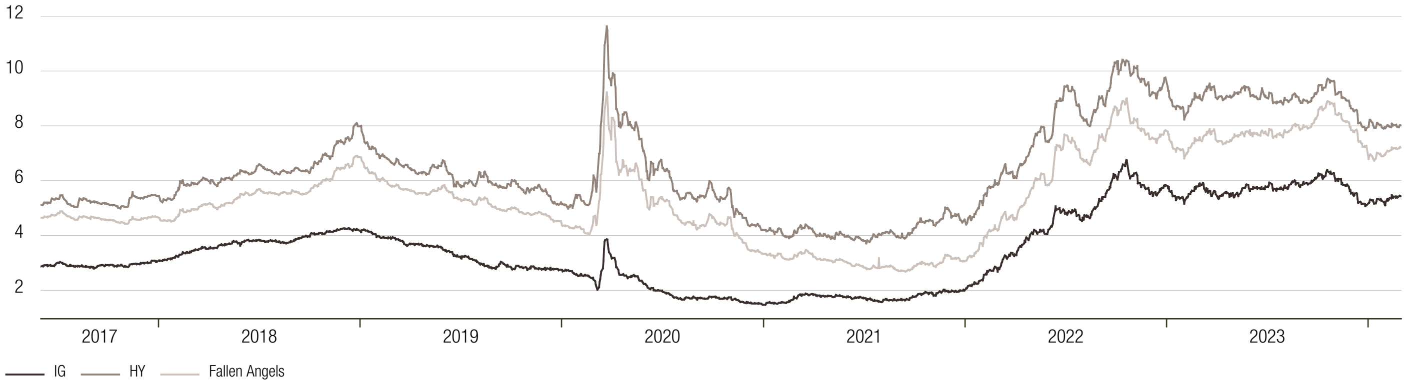
Source. LOIM, Bloomberg. For illustrative purpose only. Past performance is not a guarantee of future results.

FIG 3. Historical corporate spreads (bps)



Source. LOIM, Bloomberg. For illustrative purpose only. Past performance is not a guarantee of future results.

FIG 4. Historical corporate yields (hedged in USD)



Source. LOIM, Bloomberg. For illustrative purpose only. Past performance is not a guarantee of future results.

FIG 5. FUND PERFORMANCE

29.2.2024	Inception date	MTD	YTD	ITD	AUM (mn CHF)
LOF Fallen Angels Recovery (USD Hdg) NA	30.11.2021	-0.11%	0.12%	0.68%	**355**
Bloomberg Global High Yield Corporate (USD Hdg)		0.35%	0.58%	1.47%	
Bloomberg Global Corporate ex EM Fallen Angels 3% (USD Hdg)		-0.32%	-0.58%	0.31%	
Relative performance (Global High Yield)		**-0.46%**	**-0.47%**	**-0.79%**	
Relative performance (Global Fallen Angels)		**0.20%**	**0.70%**	**0.37%**	

Source: LOIM. Note: Past performance is not a guarantee of future results.
For further information please visit: https://www.lombardodier.com/funds.

FIG 6. Yield and duration

29.2.2024

Characteristics	Portfolio	High Yield Index	Fallen Angel Index
Positions	285	2696	230
Issuers	126	1187	108
Coupon (%)	4.58	5.84	4.52
Yield to worst USD Hedged	6.77	7.86	7.19
Yield to worst CHF Hedged	2.92	4.01	3.34
Yield to worst EUR Hedged	5.17	6.26	5.59
Option adjusted spread (bps)	271	316	286
Duration (yr)	3.11	3.1	4.21
Average rating	BB+	BB-	BB+

Source: LOIM. Note: Past performance is not a guarantee of future results.
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FIG 7. Sustainability metrics

29.2.2024

Sustainability metrics	Portfolio	High Yield Index	Fallen Angels Index
LO Portfolio Temperature Alignment [1]	2.6	3	2.7
Carbon Investment Ratio [2]	523	835	753
ESG Materiality Rating	B-	C-	C+

Source: LOIM. Note: Past performance is not a guarantee of future results.
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[1] LOPTA refers to Lombard Odier Portfolio Temperature Alignment, our science-based proprietary framework that analyses portfolios' temperature pathways and alignment to the 2015 Paris Agreement.
[2] Carbon Investment Ratio is TeqCO2 per MUSD invested.

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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IMPORTANT INFORMATION

RISK AND REWARD PROFILE

SRI score: 3 (1 : Lower risk - potentially lower rewards; 7 : Higher risk - potentially higher rewards)

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