Wellington Euro High Yield Bond Fund

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MARKET REVIEW

Additional signs of economic weakness in the US prompted a greater-than-expected Fed rate cut. In Europe, monetary policy easing continued as the euro area economy remained at a standstill while inflation pressures abated. Most fixed income sectors produced positive total returns and outperformed duration-equivalent government bonds.

Euro high yield returned 1.03% (in local currency terms) in September, as measured by the ICE BofA Merrill Lynch Euro High Yield Constrained Index, outperforming duration equivalent government bonds by 0.12%. The option-adjusted spread of the index slightly tightened by 1 basis point to 342 basis points.

Eurozone manufacturing activity moved deeper into contraction. Germany's industrial production declined on a slowdown in the automotive sector, and the IFO business climate index fell for a fourth straight month. UK's S&P global manufacturing PMI dipped below estimates but stayed in expansionary territory, while year-over-year CPI remained steady on account of sticky energy prices.

FUND PERFORMANCE AND ATTRIBUTION

- The portfolio outperformed its benchmark during the month.
- In aggregate, sector allocation had a positive impact on relative performance during the month. An underweight to the automotive sector and overweight to government & government related contributed to relative results. In contrast, an overweight to the technology sector and overweight to consumer cyclical services detracted from relative results.
- In aggregate, security selection had a negative impact on relative performance during the month. From a sector perspective, the largest detractors were security selection within government & government related and the financial institutions industries. In contrast, the largest positive contributors were security selection within health care and wirelines.
- The largest relative detractor was an overweight to Faurecia and the largest relative contributor was an underweight to ZF Friedrichshafen.
- Faurecia (now Forvia) is a French manufacturer of automotive parts and accessories. We are positive on Forvia given continued deleveraging supported by its $1 billion asset disposal plan and improving margins and free cash flow. ZF Friedrichshafen manufactures parts for passenger cars, commercial vehicles, and industrial technology. We are cautious on the issuer based on disappointing margins and FCF. Continued portfolio actions should be supportive of debt paydown and IG ratings over the medium term.

FUND POSITIONING AND OUTLOOK

- The Fund remains positioned with a modestly defensive risk posture as high yield spreads remain tight. However, we think further bouts in volatility may present opportunities to tactically increase risk at more attractive valuations. Our largest sector level overweights are in the technology and packaging sectors. Within technology, our exposure is focused on issuers that have stable, recurring revenue sources such as software service companies and cybersecurity providers. On the other hand, we are more cautious on sectors experiencing increased capacity and therefore remain underweight the automotive sector. In terms of credit quality, the fund remains underweight BB-rated bonds and overweight investment grade and B-rated bonds.
- From a macroeconomic perspective, a soft-landing scenario appears to be playing out in the US economy and the Fed began easing. While market expectations call for the Fed to slow its pace of cuts, the risk is that they potentially move to keeping rates flat or increasing them again - the "false landing" scenario. As we move into the fourth quarter, the US presidential election is in focus as the market begins to digest potential policy changes which may be a source of volatility. We don't think higher interest expense alone will trigger a wave of defaults. Instead, a decline in earnings will be the primary driver of weaker corporate fundamentals, so we prefer companies with stable to improving credit profiles.
- We believe default rates are likely to stay around long-term averages over the next 12 months. We do not see a full-scale default cycle on the horizon given the higher quality composition of the high yield market relative to past cycles. In terms of valuations, high yield spreads remain inside historical medians although we believe current yields may be attractive to longer-term focused investors. Euro high yield valuations continue to appear more attractive relative to the US, particularly when controlling for compositional differences at the sector and rating level.

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