Wellington Euro High Yield Bond Fund

WELLINGTON MANAGEMENT®

MARKET REVIEW

Most fixed income spread sectors generated positive total returns and outperformed duration-equivalent government bonds as spreads narrowed. Most global sovereign yields declined markedly on cooling US economic releases, receding European election risks, and expectations of more aggressive Fed policy easing.

Euro high yield returned 1.25% (in local currency terms) in July, as measured by the ICE BofA Merrill Lynch Euro High Yield Constrained Index, outperforming duration equivalent government bonds by 0.34%. The option-adjusted spread of the index widened by 3 basis points to 356 basis points.

Eurozone manufacturing PMI fell further into contractionary territory, and industrial production declined, led by Germany and France. Germany's industrial production plummeted, owing to supply chain challenges impacting the automotive segment. UK's manufacturing and services PMIs each expanded.

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 packaging detracted from relative results.
- In aggregate, security selection had a positive impact on relative performance during the month. From a sector perspective, the largest contributors were security selection within technology and the wirelines industries. In contrast, the largest negative detractors were security selection within government & government related and other industrial.
- The largest relative contributor was an overweight to SFR Group Sa and the largest relative detractor was a lack of exposure to Intrum AB.
- SFR Group, owned by Altice, provides telecom and media services. The bonds have recovered following a drawdown after announcement of management's potential plan for an LME. We are maintaining exposure but are monitoring SFR closely. Intrum AB, is a Sweden-based Credit Management Services company. We remain underweight Intrum as the firm recently retained external advisors to assist with balance sheet management, increasing the possibility of a potential distressed debt restructuring.

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, economic data is slowing in the US and remains stable in Europe while the pace of inflation is decelerating globally. We believe the Fed is in a challenging position of balancing not declaring victory too soon on inflation, while also worrying more about growth and keeping the expansion going. As we move into the second half of 2024, the US presidential election cycle has come into focus as the market begins to digest potential policy changes which may be a source of volatility. Overall, we now believe a soft-landing scenario is the most probable outcome, although the risk of a mild recession remains. 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. However, 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 create an attractive entry point for 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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