TwentyFour ASSET MANAGEMENT

31 January 2019

TwentyFour Income Fund

Market Commentary

The late December rally carried on throughout January, with risk assets taking heed from a strong US employment report and supportive comments from the Federal Reserve, resulting in the best month for the S&P 500 since October 2015. Uncertainty over the US-China trade negotiations, the US government shutdown and poor economic data from China and Europe helped rates markets perform over the same period.

The stand-off between Trump and the Democrat-controlled House of Representatives over funding for a wall at the Mexican border shut the US government down for 35 days (the longest closure in history), though a temporary resolution was agreed which expires on the February 15. Both sides citing the need to reach a quick solution as economists estimate that for every week of the closure the economy is impacted by 0.1%.

Trade talks between China and the US took place early in the month and while the rhetoric was upbeat, there was scant detail but the market was encouraged as President Trump said he intends to meet Premier Xi in order to secure a concrete deal by March 1, after which tariffs on Chinese goods will increase to 25%.

In the UK, Brexit dominated headlines with multiple parliamentary votes held over the month. Prime Minister May's government submitted a plan defeated in the House of Commons by a margin of 230. Parliament did finally agree for May to go back to the EU in order to renegotiate the Irish border backstop, though initial comments from EU officials suggested this would not be considered. Uncertainty persists, with May expected to return to the EU and then report back to Parliament on February 13-14.

Disappointing economic data from China, with low GDP growth, led to a slight stall in the equity rally, with big tech stocks being particularly hit until Apple released its results and its shares rallied almost 7% on the news. Italy returned to the spotlight for all the wrong reasons as it reported a declining GDP for the second quarter in succession, its first recession since 2013. Despite this, BTPs still finished the month tighter. Earnings season has so far helped maintain a positive tone, with a number of European banks reporting better than expected numbers. High yield and AT1 deals have been limited so far in Europe, unlike the US where high yield supply has been buoyant.

January finished on a positive note as the Fed struck a dovish tone, with Chairman Powell removing references to the next hike and instead declaring a "patient" approach to future adjustments. In his press conference, Powell cited downside risks of trade tensions, Brexit, growth in China and Europe, US government shutdown concerns and a net tightening of financial conditions. These comments saw a bull steepening of the yield curve and the S&P 500 rallied by around 1.5%, the first time equities have rallied on a Fed day since Powell took the role.

The European ABS market In January experienced the quietest month in primary markets for several years, with no transactions priced. This was mainly due to the implementation of the new EU-wide STS regulations (Simple, Transparent, Standardised), which came into force on January 1. While these apply mainly to the prime part of the market, the minutiae of the detail required for certification has still not been fully clarified, which has understandably led to a hiatus of issuance. For issuers, there is little advantage to being the first mover, with the risk of launching what could ultimately be an orphaned deal into the market if it subsequently transpired the deal did not qualify. There is speculation in certain quarters that this might drag on into the second quarter or even longer, though this seems unlikely. That said, in other asset classes where issuers would never apply or qualify for STS certification, the market was equally muted. This was in part a knock-on effect from the lack of market direction due to no directional issuance, and it really comes down to the outright level of spreads and economics of the deal. Traditionally the ABS market kicks off in January with multiple deals across different asset classes and differing collateral, enabling the market to reset secondary prices and giving transparency to issuers and investors as to what the appropriate clearing levels on bonds should be.

In the CLO market, the very low primary supply seen towards the end of 2018 carried on into January, with just one primary deal priced towards the end of the month. As followers of our blogs will be aware, this is in the most part due to CLO arbitrage not currently functioning from an economic perspective; liability spreads in the CLO structure widened in the latter part of the year and the underlying loan prices have been relatively stable with fundamental performance as expected, making it uneconomical to bring deals to the market with spreads at multi-year wides. Primary CLO supply is waiting in the wings with several managers looking to bring transactions to the market in February in anticipation of more favourable conditions returning. It is worth noting that in and attempt to close the arbitrage gap and get deals launched, structuring techniques have been modified, making transactions less bondholder friendly. Examples of this are deals with less credit enhancement and weaker credit ratings. In the absence of an active primary market, secondary trading was quite active in the first part of the month and stayed constructive throughout January as the ABS market caught up with the bounce in wider credit markets and spreads tightened modestly. This was also in part generated by a large volume of BWIC activity during the first two weeks, which was all readily absorbed by investors as sentiment improved.

Portfolio Commentary

After a relatively quiet period into the year-end driven by subdued investor sentiment and a weaker market backdrop, the portfolio managers were more active during January. Having increased liquidity in the fund and reduced credit duration in prior months against a weaker macro backdrop, the managers selectively added risk at yield levels which have not been achievable for several years.

Investments were made in secondary UK non-conforming and prime RMBS, consumer ABS senior and mezzanine bonds and the managers also increased an allocation to a private transaction. This was funded via sales of some very short dated liquidity AAA assets, together with inflows. Modestly tighter spreads in the latter part of the month gave rise to the opportunity to sell some positions in longer dated CLOs, as we have seen the basis between secondary and primary widening, to reduce the overall size of exposure. The portfolio managers have not added CLO exposure from deals either priced or being marketed for Q1, due to the structuring features referred to in the commentary. Fundamental performance across all asset classes remains robust and given the low level of primary issuance the technical should be supportive of spreads. Despite weaker investor sentiment at the beginning of the month secondary market liquidity provided by market makers was solid. The focus continues on maintaining appropriate levels of liquidity and shorter duration bonds.

The fund returned -0.25% (NAV per Share) for the month with 3yr volatility at 5.22%.

Further Information and Literature:
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Market Outlook and Strategy

It was encouraging to see some confidence return to European ABS in January, with some fresh impetus in our market supported by wider credit markets. As anticipated in our year-end commentary, the primary market was indeed subdued due to regulatory reasons, though we do expect to see new RMBS and consumer deals in February. Certain issuers will take a pragmatic approach to funding as it is required, as opposed to seeing it as a necessity to get deals placed with an STS label. There appears be strong investor demand for bonds at these higher yields, which should provide a decent technical backdrop for the market in the near term. In the CLO market there is a steady pipeline building, but with the CLO arbitrage being the most uneconomical since the resurgence of the market in 2013 it is unlikely we will see the same sort of issuance levels we saw in Q1 2018 unless this changes. In the meantime, a move to weaker terms and conditions in the transactions in order to place deals will probably be pushed back on by investors and is the reason why we have not participated in any deals year-to-date.

In the wider market backdrop the tone remains supportive for credit, but there are unpredictable events that could alter sentiment. Here in the UK, the next key date in the diary is February 13-14, when we see yet another parliamentary vote on the Brexit plan. The likelihood of this passing is uncertain at the moment; a lot depends on the concessions Prime Minister May can get from her EU counterparts. If unsuccessful, some believe we would see an extension of the March deadline for exit, which would likely be supportive for sterling denominated risk assets. However, the chances of a no-deal Brexit and a possible general election cannot be discounted, and thus the portfolio managers maintain a prudent approach until greater clarity is delivered. Given the uncertainty, the portfolio managers maintain a focus on a balanced portfolio with a mix of shorter duration assets.

Fund Managers

Robert Ford
Partner, Portfolio Manager, industry experience since 1986.

Ben Hayward
Partner, Portfolio Manager, industry experience since 1998.

Aza Teeuwen
Partner, Portfolio Manager, industry experience since 2007.

Douglas Charleston
Partner, Portfolio Manager, industry experience since 2006.

John Lawler
Portfolio Manager, industry experience since 1987.

Luca Beldi
Portfolio Manager, industry experience since 2013.

Key Risks

- **All financial investment involves risk. The value of your investment isn't guaranteed, and its value and income will rise and fall. Investors may not get back the full amount invested.**
- Past performance is not a reliable indicator of future performance, and the Fund may not achieve its investment objective.
- The Fund invests in structured credit products or asset-backed securities (ABS). The issuer of such products may not receive the full amounts owed to them by underlying borrowers, which would affect the value of the Fund. Credit and prepayment risks also vary by tranche which may affect the Fund's performance.
- The Fund has the ability to use derivatives, including but not limited to FX forwards, for hedging only (EPM). This may magnify gains or losses.
- Typically, sub-investment grade securities will have a higher risk of issuer default, and are generally considered to be more illiquid than investment grade securities.

Further Information

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Further information on fund charges and costs are included on our website at www.twentyfouram.com