

Performance (in %)

	Q1/13	YTD	1 y. p.a.	3 y. p.a.	5 y. p.a.
B EUR	0.3	0.3	10.2	6.1	4.7
I EUR	0.5	0.5	10.9	6.8	5.3
Index	0.6	0.6	8.2	5.6	6.0

Benchmark: Merrill Lynch EMU Corporate A-BBB

Source: Bank Vontobel AG. Past performance is not a guide to current or future performance. The performance data do not take account of the commissions and costs incurred on issue and redemption. The return of the fund can be a result of currency fluctuations rise or fall.

Market developments

During the first quarter of the year, credit returns, whilst still positive, were much more subdued than at the beginning of 2012. Investment-grade corporate bonds denominated in euros recorded gains ranging from +0.3% to +0.8% with industrial companies being the outperformers at +0.8%.

This subdued performance can be explained by rising government-bond interest rates in "core" countries of the euro zone during the second part of January. In addition, the uncertainty surrounding the Italian parliamentary elections and the efforts to save Cyprus from financial collapse induced some temporary volatility in spreads – the differences in yield between lower-rated bonds and comparable "benchmark" bonds.

The events in Italy and Cyprus have had a negative impact on bonds issued by financial institutions as well as utilities as a large part of the issuers of the utilities segment are domiciled in so-called peripheral countries. Spreads of senior debt issued by banks widened by 19 basis points (bp) in the quarter while those of lower-tier-two (LT2) bank bonds widened by 29 bp. Insurance companies' subordinated debt held up much better and spreads of tier-one bank bonds tightened a few basis points. The better performance of bonds issued by industrial companies stemmed from accruing coupon payments as their spreads were more or less unchanged (except for utilities).

The events in Cyprus and Italy do not represent an immediate threat to sentiment, in our opinion, given an upbeat mood regarding the US economic outlook. In Italy, the political process appears to be moving in the right direction: leftwing leader Pier Luigi Bersani will likely try to form an alliance with center-right Silvio Berlusconi again, naming new possible government officials to get wider support from both houses of parliament. At this stage, he is apparently aiming to sideline political newcomer Beppe Grillo, whose lack of direction has already angered many of his supporters.

One word on Cyprus, though: we do not believe that the resolution should be seen as a template for future bailouts in the European Union given that a considerable amount of the money on Cypriot bank accounts is from Russia. We are of the opinion that it is truly a one-off resolution, as assured by the German government. That said, losses to bondholders as part of a European rescue effort ("bail-in") appear increasingly possible. As a result, we prefer subordinated debt at this stage, e.g. securities issued by insurance companies, bank tier-ones and lower-tier twos which price in bail-in risk. By contrast, senior bank-bond spreads currently do not fully reflect this risk. Their re-pricing could happen sooner rather than later as they lose their ratings uplift from the ratings agencies.

The fact that the markets remain flooded with liquidity should also ensure that the technical picture of the European credit market stays favourable for the rest of 2013. Bank deposit bases in the EU are growing at an average of 2% annually, adding at least 500 billion euros of new liquidity every year. This comes against the backdrop of decreasing loan growth. As a result, any repayments of loans by banks which took advantage of the European liquidity LTRO (long-term refinancing operations) programme should not be seen as a threat to the ample liquidity.

Portfolio review

The structure of the portfolio was not altered much with the main positioning in subordinated debt remaining unchanged. In the subordinated bonds segment, we shifted part of our LT2s from banks into newly issued insurance securities. We also added to hybrid bonds issued by industrial companies at the expense of senior "industrial" debt as the yields of the latter category had tightened quite a bit. As a result, our insurance weight increased to 13.5% from about 12% and our overweight in bank LT2s declined to just 4% from around 5%.

We very much like the insurance sector now relative to banks for fundamental reasons and the fact that this segment has experienced much lower volatility than banks' LT2s during the recent period of volatility. At the same time, we remain fond of the UK banks in light of the strong deleveraging trend in this sector. Corporate "hybrids" are also increasingly attractive following comments that Standard & Poor's may provide less equity credit for such instruments. This would increase the probability of early calls – repayments by issuers ahead of the maturity date. Our 4% overweight in this segment is essentially through EdF, Vinci, RWE, Linde and BG Group. Finally, we rolled over our long CDS ITRX Main index position representing a leverage of 15% of the fund to receive extra "carry" of 120 bp. This is in line with our carry theme for the year.

Performance analysis

The Vontobel Fund – EUR Corporate Bond Mid Yield posted a gain of 0.3% in the first quarter versus 0.6% for the index. The underperformance was 33 bp. In March, the fund's outperformance was 14 bp amid a net total gain of 0.6%.

We are still comfortable with our subordinated exposures amid lower European tail risks and a well-established deleveraging trend for financial institutions in Europe. Furthermore, this subordinated exposure prices-in the risk of a potential bail-in.

Outlook

In the context of very low government-bond yields, the forecast is net negative issuance this year – supply of new corporate bonds is scarce and down 34% year to date, when compared to the same period last year – and very high market liquidity. We will continue to find the valuation of corporate bonds that are fairly attractive at 126 bp on average. At these levels, spreads represent 92% of the yield of 10-year German government bonds versus only 47% in 2009, which was one the stronger credit years. Spreads have the potential to gradually continue to tighten and could revert back to their longer-term average of 100 bp. Should this be the case, returns in the region of 4% for our mid-yield fund are plausible thanks to our careful selection and our exposure to high-yielding subordinated securities.

Fund information

Share Class	Currency	ISIN	Inception Date
A	EUR	LU0153585566	27/09/2002
B	EUR	LU0153585723	27/09/2002
H	CHF	LU0863290267	16/01/2013
I	EUR	LU0278087860	13/07/2007

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