

What are the Risks in Today's Market and What Can Investors Do?

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The world has been awash in liquidity these last few years as a result of highly accommodative global central bank policy. This liquidity created an artificial climate of historically low rates and low volatility. We believe we are now in a period of regime change - both in terms of rates and volatility - as central banks like the US Federal Reserve ("Fed") move towards rate policy normalization. It is important, in this environment, to understand exactly where risk lies and what can be done to mitigate these risks.

Given solid macro-economic data, generally positive corporate earnings/outlooks, well capitalized corporate balance sheets and a benign default outlook, we do not believe that credit is an area of risk at the current time. Instead, we believe investors should be more concerned about rates (longer duration bonds) and passive investment strategies - areas that we believe should be closely examined in the current environment.

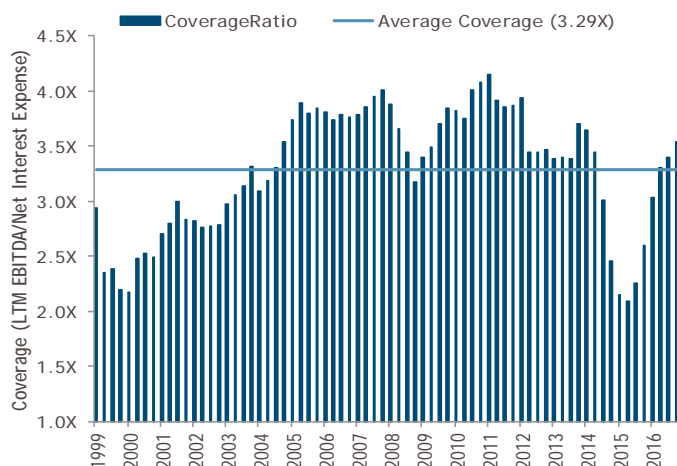
We find exposure to less duration sensitive fixed income (like high yield and loans) affords investors a degree of protection against rising rates while providing coupon income.



Bryan Petermann - Portfolio Manager

Bryan is a Portfolio Manager at Muzinich and has 28 years of corporate credit experience. Prior to joining Muzinich, Bryan worked for Pinebridge Investments (formerly AIG Investments) where he served as Managing Director, Head of High Yield for the last five years of his tenure. Bryan started his career in the banking sector. He worked in the media and cable groups at the Union Bank of California and Banque Paribas. Previously, he participated in the start of Société Générale's cable and media group. Bryan received a B.A. from the University of California, Los Angeles where he was a Phi Beta Kappa scholar, and an M.B.A. from the University of California, Berkeley.

Fig. 1 - Fundamentals Remain Strong as Evidenced by Above-Average Interest Coverage Ratios



Source: BofA ML Global Research HY Market Statistics. As of September 30, 2017. Data ex-LBO. BofA ML updates this data approximately quarterly with a 1 quarter lag because of staggered company reporting schedules. Accordingly, this data is updated quarterly with a 1 quarter lag.

Where are the risks in today's market?

Rates

Since 2013, the Federal Reserve has made clear its intent of normalizing rate policy provided economic data is sufficiently strong to support such a move. The Fed can impact the short-end of the curve through the FOMC and the Fed funds rate, while Quantitative Easing ("QE") was introduced to try and lower rates at the long-end of the curve.

A string of positive economic data (employment, inflation) over the last several months has made it more likely that the Fed will continue to raise short-term interest rates. According to Bloomberg, the market is forecasting three Fed fund rate increases in 2018 (source: Bloomberg World Interest Rate Probability).

On the longer end of the curve, the lingering impact of QE continues to decline as the Fed shrinks its balance sheet by allowing Treasuries that mature to roll-off without re-investing the proceeds. According to the Federal Reserve, we can expect to see a 35% reduction in the size of the Fed balance sheet over three years.

Fig. 2 - The Fed is Shrinking its Balance Sheet

\$ Bn	Year 1	Year 2	Year 3	Cumulative
Treasuries	180	360	360	900
Agency/MBS	120	240	240	600
Total	300	600	600	1500
% of Total Holdings (at time of calculation)	7.05%	15.2%	18%	35.3%

Source: Federal Reserve, Muzinich as of July 2017

Outside of the Fed, some large buyers of US Treasuries, like China and Japan, have reduced their holdings of US Treasuries (source: Bloomberg, China's Holdings of Treasuries Slump to Lowest Level Since July, January 17, 2018).

Rates at the long-end of the curve are mostly a function of supply/demand dynamics so a decline in demand leads to lower prices and higher yields (bond prices and yields are inversely correlated).

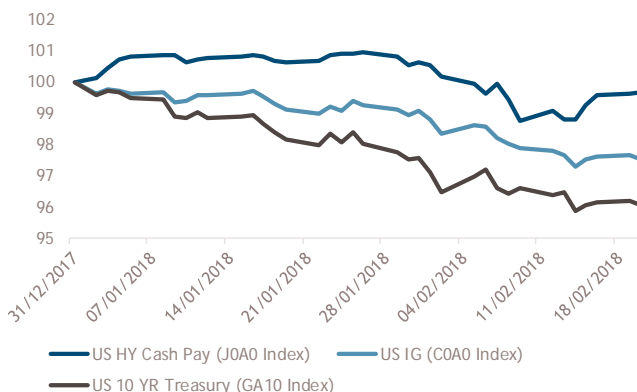
Speculation as to the reason for the decline in foreign purchases ranges from concerns about the impact of rising US deficits and their inflationary potential as well as a reaction to some of the protectionist trade rhetoric emanating from the White House.

On the supply side, rising deficits will also likely lead the government to increase its borrowing. In the last week, the Treasury issued the second largest amount of debt ever over a three-day period (source: Reuters).

We would like to emphasize that rising rates impact on fixed income varies significantly by duration profile. Longer duration bonds like sovereign debt or investment grade corporates will likely face the steepest price declines should rates materially increase.

Less duration sensitive credit, like high yield and loans are better able to absorb rate increases thanks to their excess spread or in the case of loans, floating rate nature. Fig. 3 compares year-to-date (YTD) returns for US high yield, investment grade corporates and the US 10 year Treasury. The YTD returns highlight high yield's resilience in a period of rate rises.

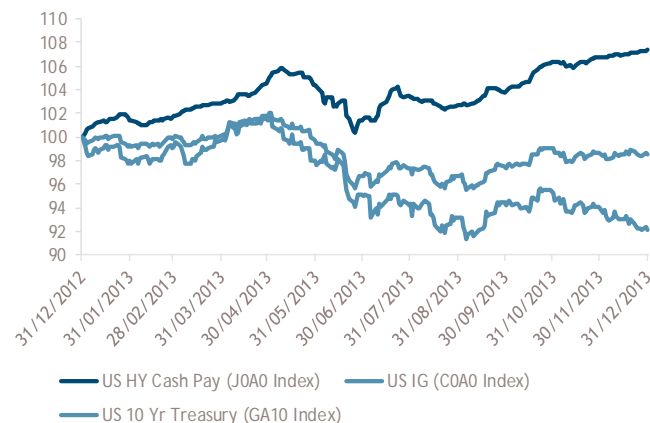
Fig. 3 - The Resilience of High Yield



Source: ICE BofA Merrill Lynch, as of 20 February 2018

When did we last see a period of rate rises? In 2013, rates rose in reaction to the Fed's announcement that it would begin tapering of QE. As would be expected, longer duration fixed income like investment grade corporates and Treasuries experienced the sharpest declines and had a more challenging time recovering. While high yield was not immune to the initial move in rates in May and June of 2013, it recovered nicely and finished the year with a 5+% return.

Fig. 4 - Fixed Income Returns in the Year of the Taper Tantrum (2013)



Source: ICE BofA Merrill Lynch, as of 31 December 2013

Passive Investment Strategies

Since the financial crisis of 2008/2009, global interest rates and market volatility reached historic lows. This environment was artificial, created by the global central banks and their monetary policies and allowed passive strategies, like ETFs, to do well as credit differentiation did not matter.

As rates rise and volatility returns, however, we expect passive investment strategies will likely underperform.

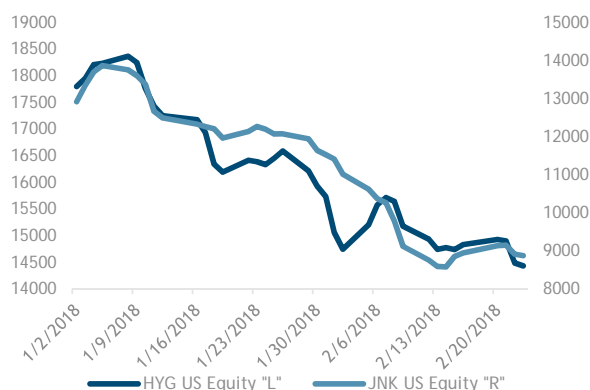
One notable example is the Credit Suisse Inverse VIX Short Term ETN which declined by 90% and has been effectively liquidated by the issuing bank. In the fixed income world, high yield ETFs like HYG and JNK have underperformed during periods of stress this year given their passive approach to investing.

ETFs have lost material assets and trading activity has dampened their returns as ETF managers have been forced to sell assets in periods of market stress. ETFs, in their need to replicate the index, will buy all credits in the index, even those nearing bankruptcy.

The high yield company iHeartMedia (formerly ClearChannel Communications) recently missed a bond payment, yet the ETFs still hold positions in the name. Muzinich portfolios did not hold this credit due to our active credit underwriting and portfolio management; we focus on cash flow producing assets and principal protection.

Fig. 5 highlights total fund assets year-to-date for the two largest high yield ETFs – the HYG and the JNK. Fund assets for the JNK declined by approximately 45% and 23% for the HYG. The wild swing in assets implies that investors see these ETFs as a tactical trading tool, not as a buy-and-hold investment strategy

Fig. 5 – Total Fund Assets - HYG and JNK (YTD)



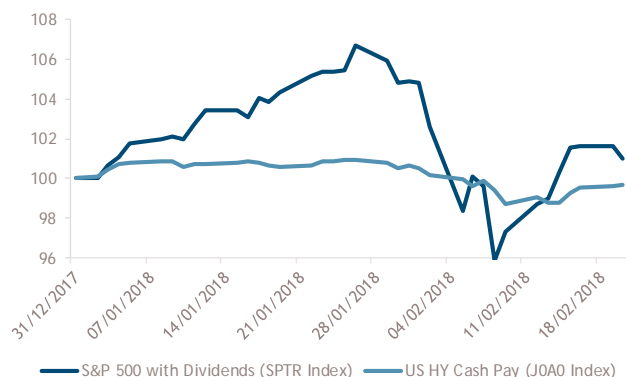
Source: Bloomberg, as of 23 February 0218

Increased Volatility

As rate policy changes, we expect to see increased volatility. We believe equities will likely be most directly impacted by this increase in volatility.

While bonds and loans certainly face mark-to-market risk, a fixed income investor accrues their coupon income on a daily basis (so long as a company does not default), thereby evening out the return stream and dampening volatility. The chart below shows YTD performance of equities versus high yield. Equities were the more volatile asset class.

Fig. 6 – US HY Far Less Volatile Than Equities



Source: Bloomberg, as of 20 February 2018

What Should Investors Do?

The challenge for investors of course is what to do in this environment. We believe there are several areas of fixed income that are particularly attractive in the current environment.

High Yield

We like high yield as the excess spread offered by the asset class can partially offset the impact of rising rates. Moreover, solid corporate credit fundamentals and a benign default outlook mean credit is less of a concern. The stable spread environment validates high yield credit fundamentals.

Floating Rate Debt

Floating rate debt, like leveraged loans, act as a natural hedge against rising rates and inflation as they periodically adjust. Credit fundamentals remain solid and we do not anticipate an increase in defaults. Nicely positive YTD results validate the fact that credit is not leading the volatility that we have seen lately rather volatility is a by-product of rates.

Private Debt

In private debt, floating rate loans are extended to private companies. These loans are packaged into a fund structure so that investors can have exposure to a diversified portfolio of loans. Investors benefit from higher returns given the illiquidity premium offered to compensate investors for remaining invested for five to seven years.

US Dollar Investor investing in Euro-Denominated Debt

A weak dollar has created an opportunity for US\$ investors investing in Euro denominated debt due to a pick-up received when Euros are hedged back into USD.

Emerging Market (EM) Debt

We believe Emerging Markets are behind in the cycle compared to Developed Markets and thus have a longer runway of growth. The asset class continues to benefit from favorable/improving fundamentals. A weakening US\$ also means that EM debt issued in US\$ also appears cheaper for the issuer to repay.

We believe in the current environment, investors need to focus on rates and avoid passive investment strategies. What matters most with rates is the speed and magnitude of change. A gradual move higher will give the market time to adjust. A steep, quick move may initially shock the market, however, we would expect smoother sailing in fixed income thereafter provided credit fundamentals remain strong, which is likely the case given our benign default outlook. Passive investment strategies can expose investors to unnecessary duration and credit risk.

In this period of change, there are two things that are true: the need for income remains and timing markets is an exercise in futility. We believe high yield, loans and private debt present investors with attractive investment opportunities suitable to the current environment.

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Emerging Markets may be more risky than more developed markets for a variety of reasons, including but not limited to, increased political, social and economic instability; heightened pricing volatility and reduced market liquidity.

Index definitions as follows:

COA0 - The ICE BofA ML US Corporate Index tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. Qualifying securities must have an investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of \$250 million.

GA10 - The ICE BofA ML Current 10-Year US Treasury Index is a one-security index comprised of the most recently issued 10-year US Treasury note.

JOA0 - The ICE BofA ML US Cash Pay High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt, currently in a coupon paying period that is publicly issued in the US domestic market. Qualifying securities must have a below investment grade rating (based on an average of Moody's, S&P and Fitch), at least 18 months to final maturity at the time of issuance, at least one year remaining term to final maturity as of the rebalancing date, a fixed coupon schedule and a minimum amount outstanding of \$250 million.

S&P 500 - The Standard & Poor's 500 Index (S&P 500) is an index of 500 stocks seen as a leading indicator of U.S. equities and a reflection of the performance of the large cap universe, made up of companies selected by economists.

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