Capital at risk. The value of investments and the income from them may fall as well as rise and is not guaranteed. Investors may not get back the full amount invested.

Muzinich & Co. 2023 Outlook
Income is Back

January 2023

Given significant moves in 2022, we believe credit markets offer attractive carry, and we expect the excess return outlook to be positive in 2023

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Key Takeaways

- **Focus on Credit Quality -** Given the heightened recessionary risks, we advocate a focus on higher quality credits within the BBB and BB ratings segments.
- **Valuations Offer a Good Entry Point -** Following a significant sell off in 2022, credit market valuations, compared with historic and forward-looking equity returns, have returned to attractive and competitive levels - notably in Euro-denominated bonds.
- **Default Rates are Overdone -** While defaults are likely to increase, we do not believe they will reach previous bear market highs or those implied by the market.
- **End in Sight for Interest Rate Rises** - Central banks may be nearing the end of their interest rate hiking cycles, even if their final targets remain unclear.

High Quality Credit a Prudent Choice

Ahead of what is likely to be a period of economic weakness, investing in quality credit offers compelling risk/reward characteristics and appears to be a prudent investment within both investment grade and high yield. The large foreign exchange hedge premium adds to the attractiveness of euro-denominated markets. Within emerging markets, we expect investors will be rewarded by the extra spread premium versus equivalent quality US credit. Within high yield, we are focusing on the higher quality segments of BB and strong B rated credits. In Europe, we believe hybrids bonds and financial subordinated debt appear good value, as their issuers tend to be investment grade rated with little default risk. Leveraged loans also offer comfortable carry, although again we would advocate a focus on higher quality credits, with a slight overweight to US dollar denominated markets.

A Flexible Approach to Sector Allocation

Given the uncertain macroeconomic backdrop and growing recessionary risks, we maintain a preference for defensive sectors such as telecommunications and healthcare. We take a more selective approach to cyclicals, investing in credits that offer value, cash flow and a capacity for balance sheet improvement should the economic situation deteriorate. We prefer to avoid sectors linked to discretionary consumption or real estate, although the latter may soon offer selective opportunities as balance sheet repair becomes a priority.

Stay at the Short End

Currently we believe short duration strategies appear compelling given they offer less volatility, access to attractive credit market valuations and higher total yield. There will come a time to go longer duration, but we would like to see more convincing signs of a deceleration in global inflation before we change the risk mix between credit and duration. Tactical strategies may adopt a barbell strategy regarding duration to capture the value of long investment grade.

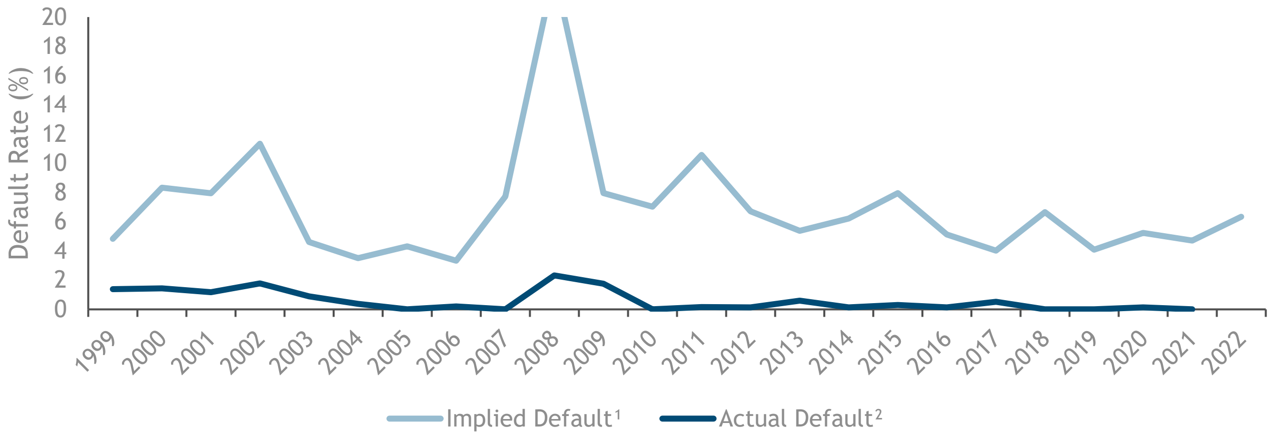
Credit markets are finally offering a carry that disappeared for many years and we expect the excess return outlook to be positive in 2023. Income is back and investors should enjoy it.

Fundamentals and Valuations – A Deeper Dive

Credit Fundamentals – Bending Not Breaking

While defaults will likely increase, we believe this default cycle should be more moderate than previous bear markets, despite what is being priced by the market (Fig. 1).

Fig. 1 – Historical BB Implied vs. Realized Default Rates



Sources: (1) Muzinich calculations using data from ICE Index Platform, as of November 30th, 2022, ICE BofA Global High Yield Constrained Index (HW0C). (2) Moody's Annual Default Study, February 8th, 2022. Most recent data available used. For illustrative purposes only.

We do not expect the bond market to be closed to new issuance in 2023. There is no wall of maturity to challenge the whole market and accentuate defaults. A confirmed recession would come as no surprise and corporates still have significant cash on their balance sheets.

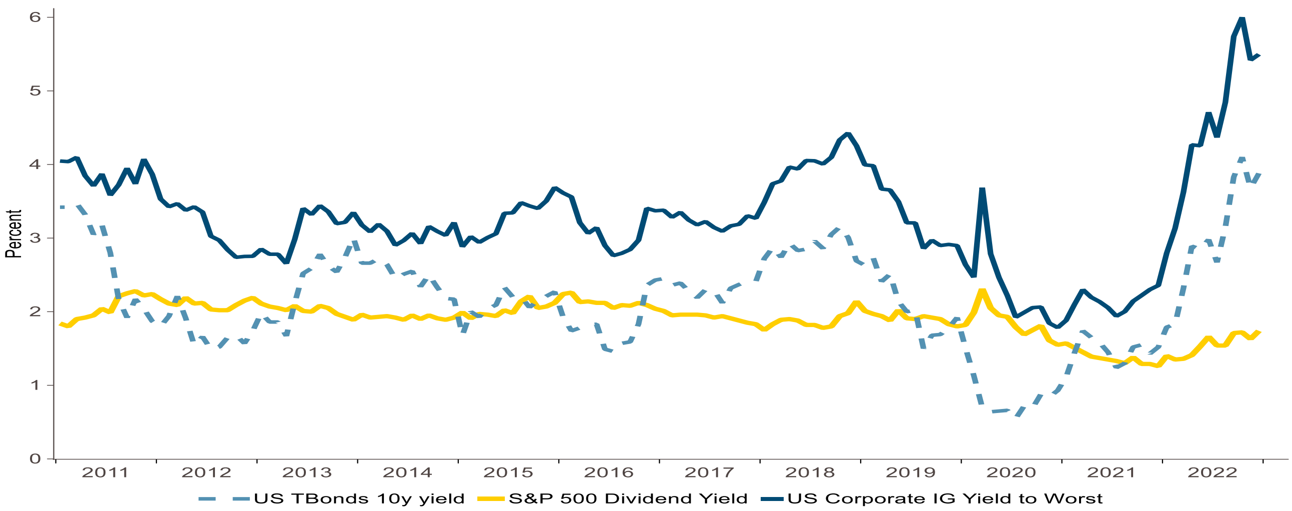
Is the market underestimating the possibility of a negative surprise in earnings next year? The fourth quarter credit spread rally, combined with lower government bond yields, suggests the market is more relaxed towards the risk of a severe recession. However, we remain vigilant with a focus on margins rather than earnings growth.

Valuations – Now at Attractive Levels

While 2022 impacted fundamentals, the price action was extremely beneficial for valuations and the 2023 investment landscape has changed completely. Income is back and investors will be able to enjoy it, wherever they invest.

Asset allocation across multi-asset portfolios is expected to be different in 2023 with a greater allocation to credit. Looking ahead, we believe equity dividend yields are likely to be a fraction of credit yields; investment grade (US or Europe) yields may be twice as high as the dividend yield, while high yield could be as much as to four times as high. Therefore, we expect credit markets to be supported by allocation decisions in early 2023.

Fig. 2 – Credit Yields More Attractive than Equity Dividends



Source: Macrobond, S&P 500 Index, ICE BofA ML Current 10-Year US Treasury Index ICE BofA US Corporate Index (C0A0), as of 31st December 2022. For illustrative purposes only.

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As we enter what is likely to be a weaker part of the economic growth cycle, we prefer higher quality credit within investment grade and high yield. Investment grade spreads appear attractive versus their long-term average (Fig. 3).

Fig. 3 Credit Market Spreads

Spread vs. 10y average (bps)	Dec 2021	Dec 2022
Euro IG (ER00)	-19	+50
US IG (C0A0)	-33	+12
EURO HY (HEC0)	-61	+101
US HY (H0A0)	-129	+27
EM IG (EMIB)	-48	-20
EM HY (EMHB)	0	+22

Source: ICE Index Platform, as of 30th December 2022. For illustrative purposes only. BofA, Euro Corporate Index (ER00), US Corporate Index (C0A0), Emerging market Corporate Plus Index (EMIB), US High Yield Index (H0A0), Euro High Yield Constrained Index (HEC0), Emerging High Yield Corporate Plus Index (EMHB).

Overweight Europe vs. US

In early 2022, we were overweight US credit which worked well given the Russia/Ukraine conflict and consequent negative impact on Europe. However, after a significant underperformance of European credit, much of the bad news was already in the price and reversed this exposure during the summer, moving to a general overweight in Europe.

Looking ahead, a diversified portfolio between the US and Europe is probably right as there are risks on both sides. US economic resilience, illustrated by strong employment, may lead to a monetary policy mistake and a sharper-than-expected macro slowdown. In Europe, the Russia/Ukraine conflict aside, high energy prices are likely to prolong both supply side issues and constraints on purchasing power.

High yield appears good value. Again, given extreme moves in 2022, the asset class is now well insulated from further significant spread moves. For the BB-B US high yield market, the current spread [380 bps] needs to widen by 190bps to wipe out the expected total return over the next 12 months if government bond yields remain unchanged.[1]

Hybrids and subordinated financials, which dramatically underperformed in 2022, also appear to offer reinvestment opportunities. We have seen many issuers refinance subordinated bonds, despite adverse economic terms, showing how committed the issuers are to these instruments in their capital structure. While interest rate hikes may not be over, these instruments in our opinion offer attractive convexity compared to the now limited downside risks and less expected volatility going forward. With senior debt well anchored in investment grade, these instruments are less exposed to potential macro disappointment.

Global Growth Outlook

How will central banks balance the final phase of rates tightening with the growing risk of recession?

A material slowdown in global economic growth in 2023 is likely as the economies of the US, Europe and China will likely weaken and their outlooks are uncertain. The impact of monetary policy changes tends to lag real economies and most of the rates transition in 2022 will be felt in 2023.

This raises the probabilities of a technical recession in the US in the second half of the year. European economies were more exposed to higher energy prices and are probably already experiencing a contraction in activity. China was not hit by monetary policy tightening but by a self-inflicted series of strategic decisions in the management of Covid and the highly levered property sector.

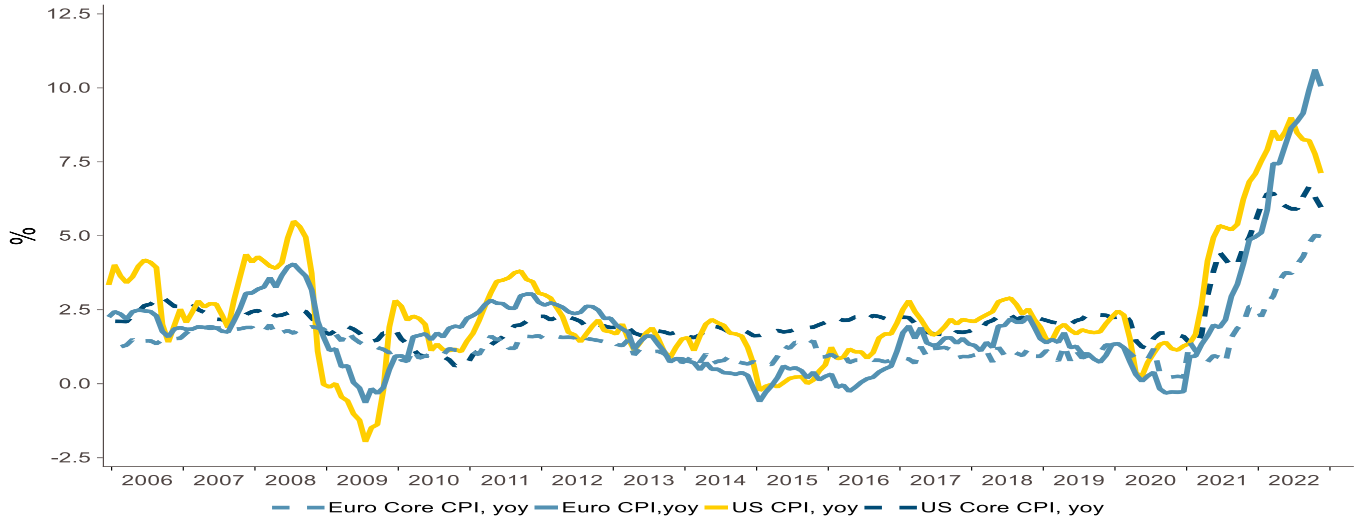
Overall, there are reasons to hope a recession can be temporary and limited after softer-than-expected inflation numbers in the US, material fiscal support in Europe for 2023 and what looks like a radical change of stance in China on Covid and the property sector.

Pace of Inflation Deceleration Key for Financial Markets

A deceleration of inflation is a monetary and political priority for 2023. The first regions to see inflation converging towards target will be the first to see the macro benefits and will likely attract international capital flows. Lower inflation helps to protect consumer purchasing power, business margins and real wages. It reduces the risks of a wage compensation inflation spiral and removes the tail risk of excessive tightening while opening the door to a “pivot” in policy rates.

[1] ICE Index Platform, as of 9th December 2022. BofA index, BB-B US High Yield Index (H0A4)

Fig.4 – Peak Inflation?



Source: Macrobond, Bureau of Labor Statistics, Eurostat, as of 30th November 2022. Eurozone Core Consumer Price Index, US Core Consumer Price Index. For illustrative purposes only.

In our view, a further and sustained decline in inflation will be needed before central banks are comfortable enough to stop raising rates. The communication challenge for central banks is to slow the pace of rate hikes without triggering a rally in financial assets. This would impair the monetary policy transmission and lead to additional rate hikes.

The December meeting confirmed the Federal Open Market Committee intends to raise rates to at least 5% by 2Q23 and keep rates high for a while. It may be more difficult to “fix” expectations for the European Central Bank (ECB) as inflation has not yet peaked convincingly. The December ECB meeting delivered a hawkish message on rates. This was aligned with our long-held view that the deposit rate facility could reach 3% by mid 2Q23, a point where the ECB should feel comfortable to wait and see how inflation deceleration is progressing and to assess second round impacts through wage negotiations.

For bond markets, if inflation deceleration is confirmed from its 3Q22 peak, it may mark the October 2022 top in yields as the high watermark for 2023. It will help reduce the extraordinary bond market volatility in 2022, a pre-requisite for sustained inflows into fixed income.

Emerging Economies

Emerging debt markets suffered heavy outflows in 2022. The triple risk of lower global growth, higher US rates and yields, combined with a stronger US dollar was an uncomfortable base for international investors. Many emerging economies tightened their monetary policies early in the cycle (Eastern Europe, Brazil, South Africa) to control inflation expectations, but went above initial targets because of the war in Ukraine and the related extra inflation shock.

Those who delayed painful rate moves are now facing the challenge of inflation expectations de-anchoring (South Korea, Philippines, Chile, Columbia). Next year will remain a macro story for emerging markets with little room for error as economic growth in developed markets will likely remain flat. The challenge for emerging economies will be to reach a position where they can unleash domestic demand to offset lower exports.
China is currently facing two challenges. First, the progressive but significant changes in the zero Covid policy should help economic recovery. Growth expectations are for real gross domestic product to grow around 4% annualised in 2023 from 2.5% in 2022. However, in the short term, relaxing Covid constraints may come with rising cases numbers, capping consumer confidence.

On the second challenge, the objective now seems well defined, i.e., avoiding any cataclysm that the Chinese economy could not afford, but without offering a state-financed blanket solution. Whether the glass is half-full or half-empty, the tail risk of a more severe downturn with insufficient support seems to have been removed.

Conclusion

We are in a transition period from a low inflation and low interest rate environment to a considerably different economic and financial landscape. There will be uncertainty and volatility in 2023. We believe that in such a scenario better quality credit offers compelling investment opportunities.

Index Descriptions

JUC0 - The ICE BofA ML US Cash Pay High Yield Constrained Index contains all securities in The ICE BofA ML US Cash Pay High Yield Index but caps issuer exposure at 2%.

HEC0 - The ICE BofA Euro High Yield Constrained Index contains all securities in the ICE BofA ML Euro High Yield Index (HE00) but caps issuer exposure at 3%.

C0A0 - 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.

C0A4 - The ICE BofA ML BBB US Corporate Index is a subset of the ICE BofA ML US Corporate Index (C0A0) including all securities rated BBB1 through BBB3, inclusive.

ER00 - The ICE BofA ML Euro Corporate Index tracks the performance of EUR denominated investment grade corporate debt publicly issued in the eurobond or Euro member domestic markets. 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, a fixed coupon schedule and a minimum amount outstanding of EUR 250 million.

ER40 – The ICE BofA ML BBB Euro Corporate Index is a subset of the ICE BofA ML Euro Corporate Index (ER00) including all securities rated BBB1 through BBB3, inclusive.

H0A0 – The ICE BofA ML US High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt 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.

EB00 -The ICE BofA Euro Financial Index tracks the performance of EUR denominated investment grade debt publicly issued by financial institutions in the eurobond or Euro member domestic markets.

EN00 -The ICE BofA Euro Non-Financial Index tracks the performance of non-financial EUR denominated investment grade corporate debt publicly issued in the eurobond or Euro member domestic markets.

CS WELLI - CS Western European Leveraged Loan Index – The CS Western European Leveraged Loan Index is designed to mirror the investable universe of the Western European leveraged loan market. Loans denominated in US dollar or Western European Currencies are eligible for inclusion. The index is rebalanced monthly on the last business day of the month instead of daily. Qualifying loans must have minimum outstanding balance of $100 million (in local currency), issuers with assets located in or revenues derived from Western Europe, at least one year long tenor, be rated "5B" or lower, fully funded and priced by a third party vendor at month-end.

CS ELLI - CS Leveraged Loan Index – The CS Leveraged Loan Index is designed to mirror the investable universe of US dollar denominated leveraged loan market. The index is rebalanced monthly on the last business day of the month instead of daily. Qualifying loans must have a minimum outstanding balance of $100 million for all facilities except TL A facilities (TL A facilities need a minimum outstanding balance of $1 billion), issuers domiciled in developed countries, at least one year long tenor, be rated "5B" or lower, fully funded and priced by a third party vendor at month-end.

H0A1 - The ICE BofA ML BB US High Yield Index is a subset of the ICE BofA ML US High Yield Index (H0A0) including all securities rated BB1 through BB3, inclusive.

H0A2 - The ICE BofA ML single-B US High Yield Index is a subset of the ICE BofA ML US High Yield Index (H0A0) including all securities rated B1 through B3, inclusive.

EMIB – The ICE BofA ML High Grade Emerging Markets Corporate Plus index is a subset of the ICE BofA ML Emerging Markets Corporate Plus Index (EMCB) including all securities rated AAA through BBB3, inclusive.

EMHB - The ICE BofA ML High Yield Emerging Markets Corporate Plus index is a subset of the ICE BofA ML Emerging Markets Corporate Plus Index (EMCB) including all securities rated BB1 or lower.

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.

You cannot invest directly in an index, which also does not take into account trading commissions or costs.

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