Muzinich & Co

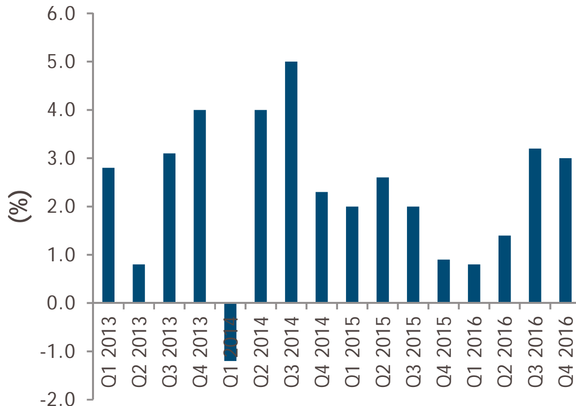
Navigating a World of Uncertainty

We live in a world of political and economic uncertainty. Post-election questions abound as to what the new US administration will do. Across the Atlantic, Europe faces several key elections (Netherlands, France and Germany) that will test the power of populist movements to significantly alter the status quo. Pollsters and pundits were not able to predict Brexit and Trump's election – how useful will they be in forecasting this coming year's elections in Europe? On the economic front, how will global central banks unwind their aggressive quantitative easing programs? Are developed market economies entering a period of secular stagnation or will short-term growth hold? Is China in a credit bubble and what will happen if it pops? Within fixed income, government rates have recently experienced sharp increases. Is this the end of a 30+ year rally in fixed income? How does an institutional investor navigate this environment?

Areas with Some Clarity/Conviction

(1) US Economic Growth. Recent US economic data has been fairly positive. According to the Bureau of Labor Statistics, unemployment has fallen to 4.6% in November as the economy continues to add net new jobs (avg. over 200k per month for the past 5 years). GDP for 3Q increased to 3.2% from 1.4% in 2Q. The combination of fiscal and tax policies proposed by President-elect Trump could provide further stimulus, prolonging an already extended economic cycle and possibly proving to be inflationary. Current headline inflation has already risen, almost doubling from last year to 1.6%.

Total Real GDP



Source: *Bureau of Economic Analysis. Estimate for Q4.*

Unemployment Rate and Monthly New Jobs (Non Farm Payroll - NFP)

Source: Bureau of Labor Statistics, as of November 30, 2016.

(2) US Corporate Credit Fundamentals Remain Strong. Companies continue to effectively manage their balance sheets, controlling costs and aggressively refinancing debt, locking in historically low interest rates and pushing out maturities. As a result, interest coverage ratios are elevated, despite a marginal increase in leverage, and near-term refinancing needs remain manageable as less than 10% of outstanding high yield credit and loans are coming due by year-end 2018 (JP Morgan). In addition, fewer defaults are expected in the energy and metals/mining sectors (which accounted for the majority of defaults YTD) given the recent stabilization of energy/commodity prices. This scenario points to a benign default outlook.

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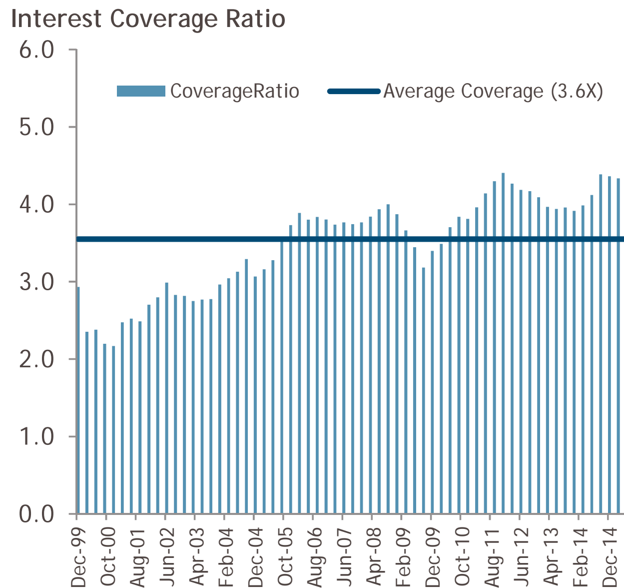
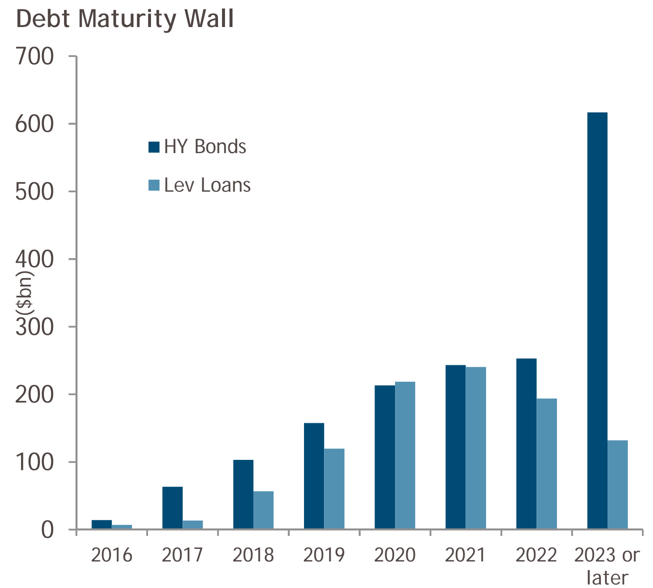
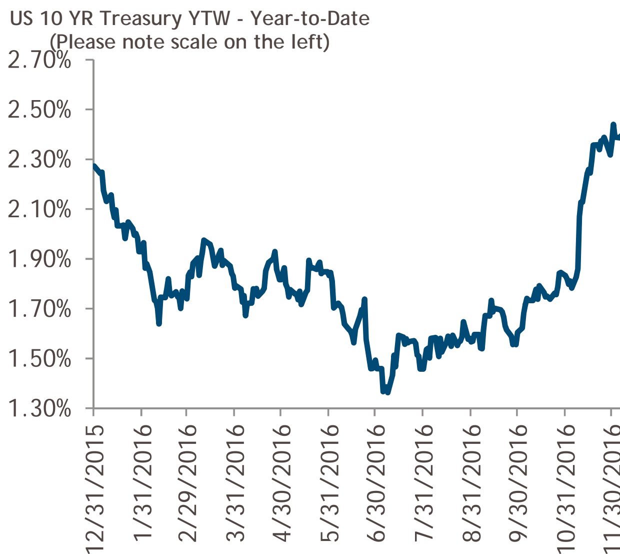


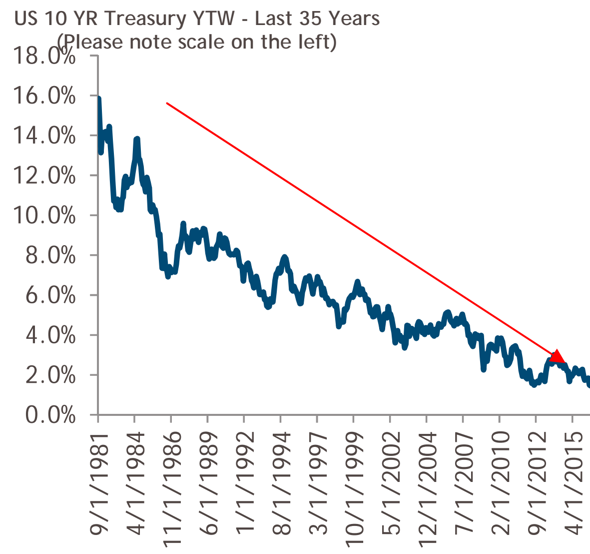
Source: BofA ML Global Research HY Market Stat. Sept. 30, 2016



Source: JP Morgan, Markit as of Aug. 9, 2016.

(3) Regime Change in Rates. The secular decline in US interest rates has lasted more than 30 years. It is likely an inflection point in rates was reached in 3Q/4Q of this year, as US Treasury yields began to rise. Expectations are for rates to be higher by year-end 2017 though the progression will likely be volatile. As a result, interest rate sensitive fixed income, such as longer dated US governments and investment grade corporates, have (and will continue to) come under pressure.





Source: BofA ML US Ten Year Treasury (GA10)

What Should Investors Do?

In the simplest terms, today's environment can be described as one of geopolitical uncertainty, potential rising interest rates and decent US economic growth. As a result, the range of possible outcomes (both positive and negative) and the potential for heightened volatility warrant investment prudence, which we believe entails:

1. Credit Risk over Duration Risk: the expectations for rising rates, a positive/improving economic landscape, and solid credit fundamentals favors spread product (credit risk) over long-duration debt. In this environment, we believe floating rate credit, such as senior secured loans (broadly syndicated and middle market), as well as short duration bonds, are attractive. These investment options offer less interest rate sensitivity, adequate yield, and, we believe, better return/risk profiles. In regard to credit quality, high yield bonds are expected to exhibit less volatility in this scenario relative to investment grade bonds due to their higher coupons and lower duration.

2. Prudent Credit Risk: given greater (overall) uncertainty, taking undue risk to capture incremental return or yield is unwarranted and we think, unwelcome should markets re-price broadly, even on headline news. More attractive return/risk profiles are available through less volatile, more defensive credit exposures, notably short duration and creditworthy (fundamentally strong) issuers. These options offer adequate yield and return potential with less potential volatility and downside risk. In addition, it should be noted that in the current investment environment (less beta driven), rigorous credit analysis and selection are crucial.

At this time, we believe a prudent approach to US (and Global) credit based on the above investment themes/outlook should help investors successfully navigate these uncertain times. What will matter is that companies can continue to pay interest and principal payments with a significant margin of safety. We will continue to focus on in-depth, detailed credit work which we believe is the key to long-term success.

December 12, 2016

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