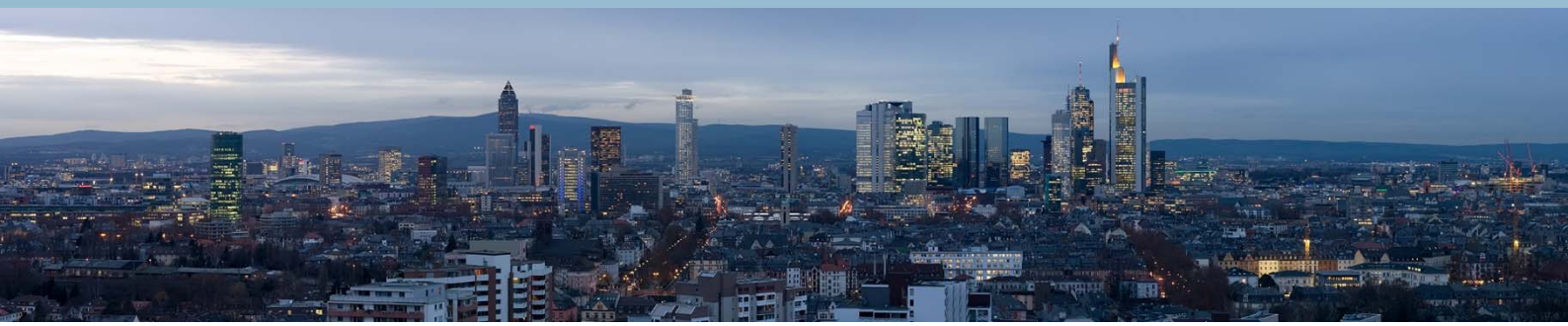
From Inflection to Transition

December 2017

VIEWPOINT

By Erick Muller & Bryan Petermann



What does 2018 have in store for corporate credit markets?

Erick Muller, MBA Bryan Petermann, MBA

Co-Chairs of the Asset Allocation Group

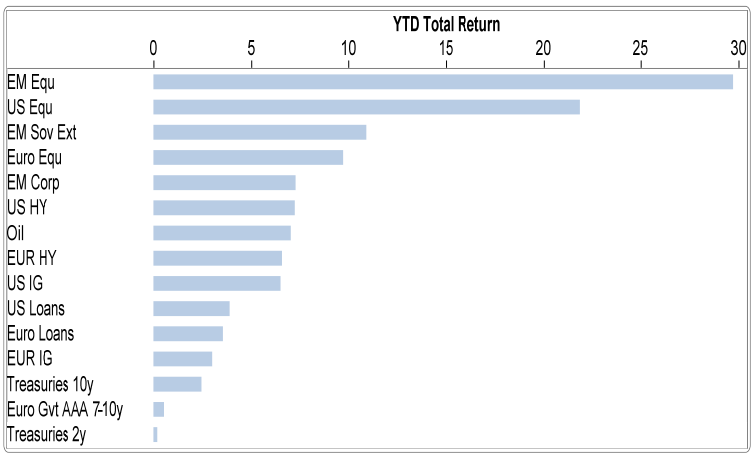
Executive Summary

- Global growth likely to remain strong and synchronised, although global central bank monetary policy will likely become less aligned
- Expect a gradual rise in inflation, which has not yet been priced into markets
- Hedging costs likely to be more pronounced between US dollar and euro/yen based investors
- Volatility likely to remain low as markets enter 2018, but will largely be dependent on inflationary trends
- Fiscal reform likely to be positive for US credit
- A focus on fundamental research should be the key determinant of underlying credit quality

A Year of Transition

Global corporate credit market returns in 2017 have been impressive, adding to 2016's already generous recovery.

Fig. 1 – 2017 Sub-Asset Class Returns



Source: Macrobond, ICE BofA Merrill Lynch Index, S&P Index as of 30 November 2017, in local currency. Past performance is not indicative of future results.

Muzinich & Co

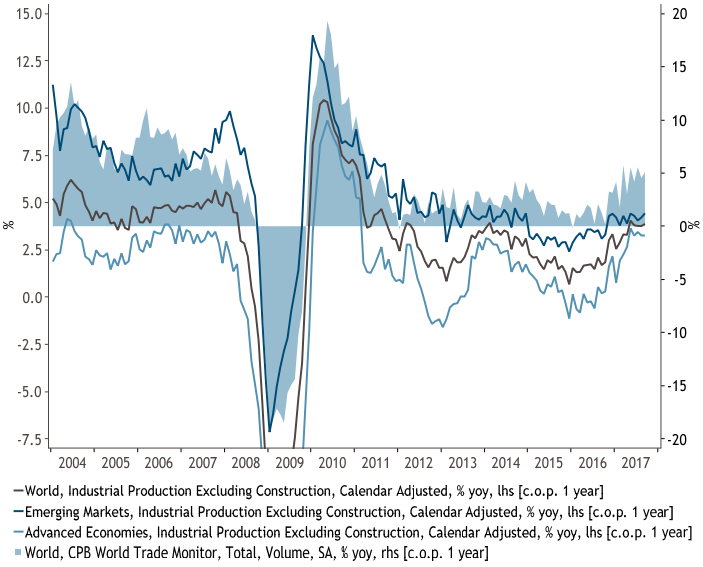
If 2017 marked an inflection point of a multi-year trend, we expect 2018 to be a year of transition; risk asset reflation is likely to fade leading to a repricing in financial markets aligned with changing fundamentals.

However, we expect repricing to be benign enough to leave carry as the dominant contributor to returns. Our expectations for credit market performance are predicated on four key themes.

1. Global Growth and Inflation

Global economic growth remains on track in quantitative (approaching 4%) and qualitative terms. It also is synchronised between developed and emerging markets.

Fig. 2– Global Industrial Production and World Trade Volumes (y/y)



Source: Macrobond, CPB World Trade Monitor, Muzinich & Co. as of September 2017.

The delayed inflation response to such a buoyant economic cycle is, however, an anomaly that we expect will be corrected over time.

Many countries should approach full employment in 2018, resulting in the re-emergence of wage growth. Anecdotal evidence from the US suggests a forecasted material wage increase of 4-5% annualised.

The inflation delay has been hugely beneficial for credit markets, allowing G4 central banks to maintain a longer period of extreme stimulus via conventional and unconventional monetary policy.

Yet while global economic growth appears synchronized, monetary policy adjustments are becoming less aligned.

The US economic cycle is vigorous enough for the Federal Reserve (Fed) to engage in monetary policy tightening via interest rate rises and balance sheet reduction, and the Bank of England has already implemented its first rate rise (but kept forward guidance extremely gradual).

Conversely, the European Central Bank (ECB) is only progressively tapering its asset purchase programme and the Bank of Japan (BoJ) has yet to move its accommodative stance beyond its yield curve control approach.

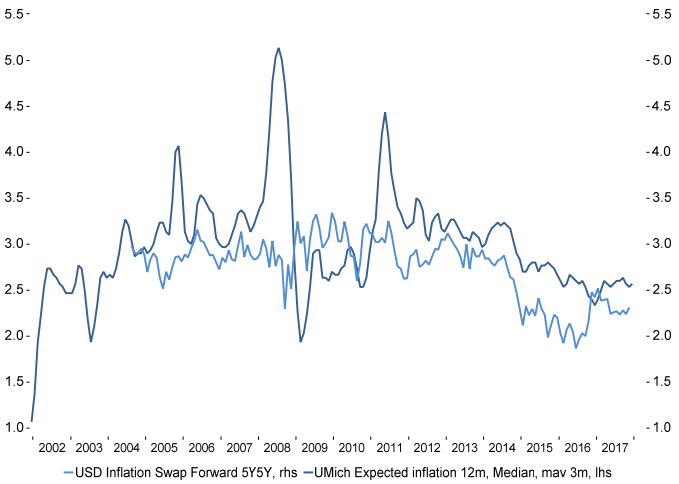
The common theme across central banks is a focus on predictability to limit any unwarranted shocks in financial conditions during a return to a more normalised monetary policy environment.

While we anticipate a gradual rise in inflation, it is unlikely to result in a bond market shock. However, it should be visible enough in the US to steepen the yield curve and push long US Treasury yields 0.5-0.75% higher.

European government bonds should follow suit, but less aggressively than the US, supported by the ECB's quantitative easing programme. Meanwhile, Germany's fiscal situation and structural demand for AAA rated collateral leaves the Bund market anchored well below 1% on a 10-year basis.

The result is government bond yields at relatively low levels thanks to subdued inflationary expectations and persistent demand from institutional investors for long-duration instruments.

Fig. 3 – US Inflation Expectations



Source: Univ Michigan expected infl. 12 fwrd and %y 5y5y fwrd inflation swap. Bloomberg, Muzinich & Co. December 2017.

Key Takeaways:

- Synchronised global growth
- Global central bank monetary policy will be less aligned
- A gradual rise in inflation not yet priced into markets

2. Liquidity and Hedging Costs

We expect global liquidity to increase; the expansion of the ECB and BoJ's balance sheets should more than offset the Fed's reduction, providing support to risk assets. This argument will vanish over the year, but is likely to prove supportive in the first half.

However, divergent monetary policy is likely to transmit into less liquidity in US dollar-denominated assets and growing liquidity in euro and yen-denominated assets.

This dynamic also suggests an increased risk of asymmetric rates tension between the US and the European and Japanese markets, combined with already high hedging costs for euro or yen-based investors into US dollars.

For euro or yen-based investors the attraction of US-dollar assets, in particular long-duration assets, has been very significant over the past two years, boosting inflows into US investment grade.

A rise in US short rates has not been fully transmitted into the long end of the Treasury curve, which has flattened to a multi-year low.

Therefore, the attraction of US dollar assets from a yield pick-up perspective has reduced. While the diversification argument remains, it is without the benefit of carry, which may not be sufficient to continue to support cross-border flows.

Conversely, US dollar-based investors can benefit from investing into euro or yen-denominated assets where the hedging cost portion of the yield provides a more predictable return feature. This is more attractive than an investment into a straight US dollar credit bond where the total return is less predictable.

Key Takeaway:

- Hedging costs more pronounced between US dollar and euro/yen based investors

3. Volatility and Correlation Dynamics

Quantitative easing, low inflation, low default rates and a buy-the-dip mentality has resulted in a decline in volatility since 2015 and valuations have reached record levels.

However, global monetary policy normalisation and a reduction in US dollar liquidity may lead to a repricing of financial assets and an increase in volatility.

While we believe these moves are likely to be gradual, there is also a risk that an adverse and unexpected geopolitical event, or sudden change in central bank policy that has not been well telegraphed, could lead to an uptick in volatility when investors least expect it.

The correlation between credit markets and duration is also expected to become more unpredictable. In a deflationary environment, taking a long duration position was a natural hedge to long credit exposure; any worsening of the economic situation would widen credit spreads but also push down yields. The economic recovery breaks this relationship and leaves the next correlation regime uncertain.

Key Takeaway:

- Volatility is likely to remain low but unexpected geopolitical or monetary policy moves could result in a sudden volatility spike
- Credit and duration correlation to become less predictable

4. US Fiscal Reform

Changing US fiscal policy is likely to have an impact on credit markets and investors should remain attentive both to US fiscal reforms and inflation behaviour against a backdrop of higher commodity prices and tighter employment.

Ongoing political wrangling has made it difficult for markets to price in the impact of US fiscal reform.

However, we would expect the net result of US fiscal reforms to be favourable for credit markets based on a positive impact on earnings and reduced bond market supply.

Key Takeaway:

- Fiscal reform likely positive for US credit

Credit Outlook

We continue to be constructive on credit, although we are cognisant of the changing investment environment and its potential impact on certain segments of the asset class.

Investment Grade

In the US investment grade market the recovery of commodity prices and the energy sector's restructuring post the 2015 crisis has proved supportive and boosted issuance. In Europe, a robust economic recovery has encouraged issuers to take advantage of lower borrowing costs while the ECB's asset purchase programme has provided further support.

Net leverage, net supply and average duration have risen in both segments of the asset class.

While investment grade corporate spreads have little protection against rising rates, regional disparities are likely to favour European investment grade.

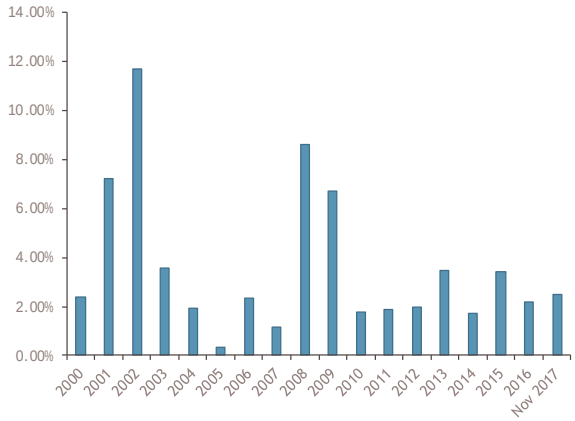
High Yield

Conversely, leverage in high yield has actually improved. The energy sector was forced to restructure in early 2016, which has benefited the asset class by purging weaker issuers, while the coverage ratio has now moved back above its long-term average.

Average credit quality has also risen with BBs comprising around 55% of the US high yield market and 75% in Europe*. This bodes well for the average default rate, which is anchored at historic lows (Figs. 4 & 5).

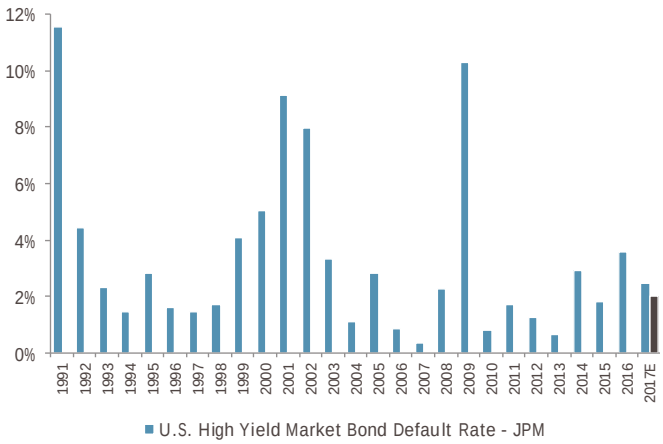
The lack of a strong merger and acquisition/leveraged buyout pipeline has left most of the primary market activity focused on refinancing, limiting new issue activity.

Fig. 4 – European High Yield Default Rate



Source: JP Morgan, as of November 2017.

Fig. 5 – US High Yield Default Rate



Source: JP Morgan, as of November 2017. 2017 blue line - actual default rate, dark line - expected

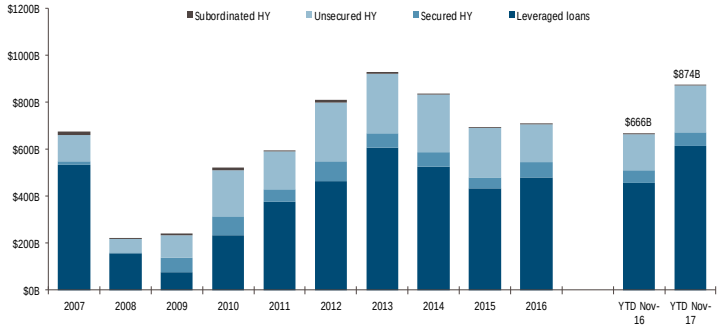
Gradual monetary policy normalization, alongside progressive and contained repricing of government bonds, compensated by stable or slightly tighter spreads, would help protect the carry available from higher-yielding assets .

We have also witnessed increased competition from the leverage loan market in funding the US high yield corporate market. The flexible nature of loans appeals to issuers with access to loan and bond markets.

As demand for loans has grown so has supply, which has in turn removed supply from the traditional high yield bond market (Fig. 6 & 7). The most visible impact of such a combination of factors is the shrinkage of US and European high yield markets in 2017.

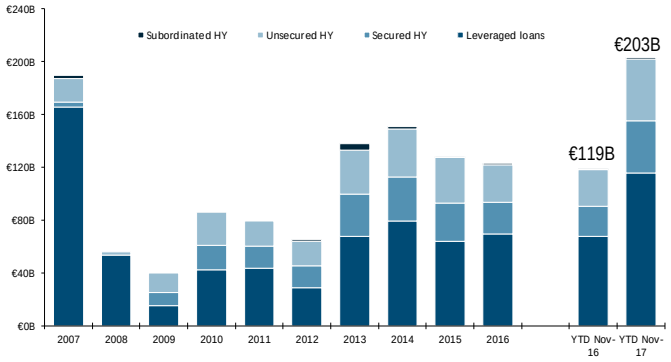
*ICE BofA Merrill Lynch US High Yield Index, ICE BofA Merrill Lynch European Currency Constrained Ex-Financials Index, as at September 2017.

Fig. 6 – US High Yield and Loan Issuance



Source: LCD, an offering of S7P Global Market Intelligence. Credit Suisse Leverage Loan Index (CS LLI) Data as of November 30th, 2017.

Fig. 7 – European High Yield and Loan Issuance



Source: LCD, an offering of S&P Global Market Intelligence, as of November 30th 2017.

One of the key determinants of future high yield supply is the evolution of US fiscal reform, in particular corporate tax cuts and the removal of interest payment deductibility from earnings.

If the initial and immediate impact is slightly negative on highly-leveraged companies' free cash flow, the longer-term impact to the market would probably be positive by limiting the appetite to finance leveraged operations through debt, and ultimately bond supply.

Loans

The US loans market has expanded materially in 2017. US corporates have been keen on rebalancing their financing in favour of loans over bonds. The CLO market has also expanded significantly, with $114.26 billion of issuance from 204 deals in 2017 (as of November), versus $71.73 billion from 155 deals in the same period last year (LCD).

Demand has been strong for the asset class in an environment of positive credit migration and reduced appetite for duration. We expect this scenario to persist in 2018, with a possible increase in M&A transactions.

Re-pricing in 2017 has lowered the margin materially and we would expect this to stabilise at current levels. On the other hand, the predictable rise in US Libor should ensure solid investor demand with expected returns for 2018 to be in the range of 4.5% - 5% in US dollar terms.

European loans are expected to perform well in 2018, with strong investor demand and growth in CLO issuance continuing after €9.4bn was issued in 2017. Although the ECB is not expected to raise rates in 2018, the loans floor at 0% should offer a solid return in the range of 3.0% - 3.5% in euro terms.

Emerging Markets

Emerging economies are benefiting from a stronger developed economic cycle and a solid domestic demand outlook for 2018. Meanwhile commodity prices are stabilizing the external accounts of producers that were hit by the 2015 energy crisis. A recovery in employment should also prove beneficial.

The risks of accelerated tightening from the Fed has largely declined since December's FOMC meeting. Consequently, the gentle rise in yields and stabilisation of the US dollar we expect for 2018 are not seen as significant for EM.

As corporate leverage is now well stabilised and international investors are increasing their exposure to EM debt, we expect the asset class should continue to do well in 2018.

Key Takeaways:

- Regional disparities favour European investment grade over US
- Default rate expected to remain low in high yield
- Expect continued solid performance from EM corporate credit and loans

Conclusion

Looking ahead, we believe 2018 offers credit investors another relatively solid year in performance terms, although not at the levels seen in 2017.

The underlying growth backdrop appears sound with synchronised growth across developed and emerging markets, which should prove supportive for the asset class.

However, the likelihood of full employment being reached should result in a move higher in inflation expectations which has not yet been priced into markets.

Tail risks are diminishing, such as in China, which has continued to surprise to the upside in 2017. While there are concerns surrounding the property market and large debt ratio, Xi Jinping's leadership has profoundly changed China's long-term objectives and altered the focus towards the quality not quantity of growth.

The investment environment is likely to be dominated by a number of trends which should lead to a gradual decorrelation in fixed income performance by rating and by region.

In the US, a solid growth trajectory should lead to a robust environment for high yield credit with strong technicals and fundamentals offsetting tighter valuations.

In Europe, high yield also appears attractive against a backdrop of solid growth and a supportive technical environment from an accommodative central bank.

For investors concerned about duration, loans and emerging market corporate credit can provide an attractive alternative.

If the rise in US yields remains gradual, and provided the US dollar does not rally too strongly, emerging market (EM) hard currency corporates should offer a resilient premium to US assets. EM corporates should also continue to capture a significant part of international capital flows as international portfolios increase their exposure.

Despite risks of higher hedging costs pervading some areas of the market, and the potential for higher inflation, overall we believe the investment outlook for credit remains healthy.

Positioning in Multi-Asset Credit Portfolios

- Maintain a preference for carry via an overweight stance to high yield
- Mitigate duration by overweighting loans where possible
- Overweight EM where possible with a focus on short-duration instruments

Asset Allocation Preferences Over 3-6 Months

Sub-Asset Class	+		Neutral		-
US HY	■				
EU HY			■		
US IG			■		
EU IG		■			
EM	■				
Loans	■				
US Treasuries					■
Bunds				■	

Source: Muzinich & Co. US HY – US high yield, EU HY (European high yield), US IG (US investment grade) EU IG (European investment grade), EM – emerging market corporate debt (high yield and investment grade), Loans (US and Europe).

About the Authors

Bryan Petermann, Portfolio Manager

Bryan joined Muzinich in 2010. He is a portfolio manager, a member of the firm's Investment Committee and a PM for the Americayield, Developed Markets High Yield and US High Yield Corporate Bond Funds. Prior to joining Muzinich, Bryan was with PineBridge Investments (formerly AIG Investments) where he served as Managing Director, Head of high yield for the last five years of his tenure. Previously, Bryan started his career in the banking sector, working in the media and cable groups at the Union Bank of California and Banque Paribas as well as participated in the start of Société Générale's cable and media group. Bryan earned 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.

Erick Muller, Director of Product and Investment Strategy

Erick joined Muzinich in 2015. His responsibilities cover macro and fixed income markets strategy and product management as well as client relationships across institutions, global distribution platforms and global private banks. Erick joined Muzinich from JP Morgan AM, where he spent nearly four years as a Senior Client Portfolio Manager. Prior to that he spent over four years as Head of Fixed Income Product Management at Fidelity Worldwide Investment and before that was Global Head of Capital Market Research at Crédit Agricole CIB for eight years. Erick started his career in finance as a European economist at SG Warburg in France. He then worked as a Senior Economist at HSBC and UBS with a particular focus on the eurozone preparation and creation. Erick has an MBA in Finance – Marketing from the ESLSCA Business School and a degree in Economics from the Université Panthéon-Assas.

Important information

FOR PROFESSIONAL CLIENTS USE ONLY – NOT FOR RETAIL USE OR DISTRIBUTION. Past performance is not a guide to future performance. The value of investments and the income from them may fall as well as rise and is not guaranteed and investors may not get back the full amount invested. Where references are made to portfolio guidelines or features, these may be subject to change over time and prevailing market conditions.

This discussion material contains forward-looking statements, which give current expectations of the Fund's future activities and future performance. Further, no person undertakes any duty or obligation to revise such forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events. Muzinich makes no representation or warranty (express or implied) with respect to the information contained herein (including, without limitations, information obtained from third parties) and expressly disclaims any and all liability based on or relating to the information contained in, or errors omissions from, these materials; or based on or relating to the recipient's use (or the use by any of its affiliates or representatives or any other person) of these materials; or based on any other written or oral communications transmitted to the recipient or any of its affiliates or representatives in the course or its evaluation of Muzinich.

The prices of fixed income securities fluctuate in response to perceptions of the issuer's creditworthiness and also tend to vary inversely with market interest rates. The value of such securities is likely to decline in times of rising interest rates. Conversely, when rates fall, the value of these investments is likely to rise. Typically, the longer the time to maturity the greater are such variations. A Fund investing in fixed income securities will be subject to credit risk (i.e. the risk that an issuer of securities will be unable or unwilling to pay principal and interest when due, or that the value of a security will suffer because investors believe the issuer is less able or willing to pay).

Any research in this presentation has been procured and may have been acted on by Muzinich for its own purpose. The results of such research are being made available for information purposes and no assurances are made as to their accuracy. Opinions and statements of financial market trends that are based on market conditions constitute our judgement and are subject to change without notice. The views and opinions expressed should not be construed as an offer to buy or sell or invitation to engage in any investment activity, they are for information purposes only. Investors should confer with their independent financial, legal or tax advisors.

This document is for information purposes only. This document is not intended to constitute an offering or placement, or the solicitation of an offer to subscribe for, units or shares in any fund, in any jurisdiction. Any such offering or placement, if made, would be made only by way of a formal offering document and only in jurisdictions in which such an offering or placement would be lawful. Such offering document will contain important information concerning risk factors and other material information. An investment into a fund may expose a person accepted as an investor in such fund to a significant risk of losing some or all of the amount invested.

Issued in Europe by Muzinich & Co. Ltd, which is authorised and regulated by the Financial Conduct Authority.

www.muzinich.com www.muzinichprivatedebt.com info@muzinich.com

New York London Frankfurt Madrid Manchester Milan Paris Singapore Zurich