Some Thoughts on the Market Correction

This is a Market of Haves and Have-Nots. Investors Should Focus on Quality

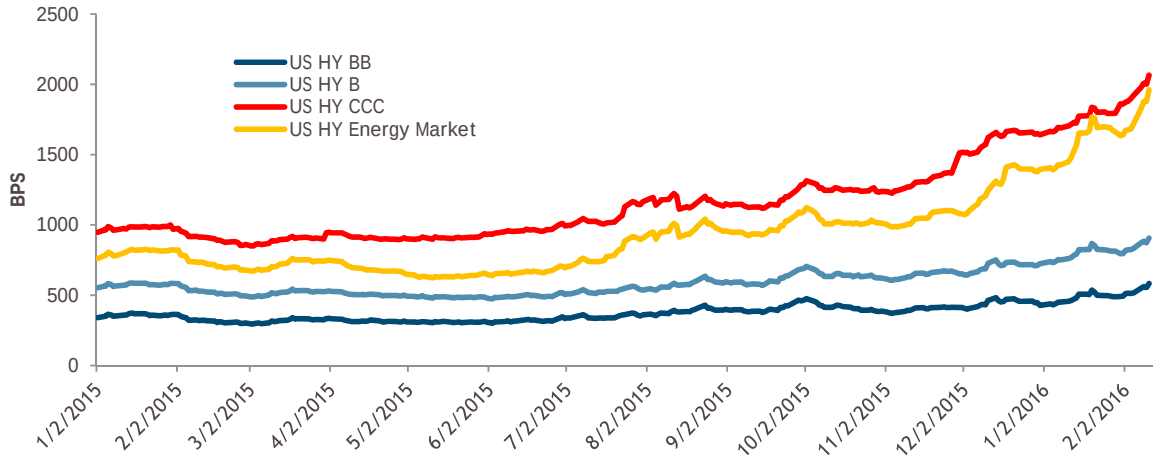
2016-to-date has been a challenging period for investors. Markets are volatile and risk-off market sentiment has made even seasoned investors very skittish. The world is awash in negative yielding paper. Approximately 25% of the global government market has a negative yield.[i] What is the yield-seeking investor to do? Should they take risk in a period of heightened volatility or should they pay a bank or government to invest in something deemed "risk-free" – essentially losing money in the long-run. We believe volatility will likely persist for a while given a variety of macro concerns (China growth, commodity price environment, European growth, European banks, possible Brexit, possible US recession, Middle East instability…the list goes on). Nevertheless, we consider current valuations compelling, although they certainly could become more attractive should negative market sentiment persist. Perfectly timing the market is an exercise in futility.

The US credit market is extremely bifurcated and the higher average yields offered by the US high yield market are a function of a minority of companies (generally troubled energy and metals/mining companies as well as CCC rated credits) trading at stressed and distressed levels. It is critical in the current environment to focus on bottom-up credit analysis and risk management. The key to risk control is to invest in the debt of companies that one believes can continue to service their debt under a variety of stress scenarios.

Current Market is Extremely Bifurcated

The US high yield market (BofA ML US High Yield Cash Pay – J0A0) is divided into two camps with 49.2% trading below a 7% yield-to-worst (YTW) and 27.4% trading above a 10% YTW. We consider the companies trading above 10% to represent the true problem credits. They are generally energy, metals/mining and CCC rated credits. We avoid these riskier, higher yielding bonds as we believe a significant portion may face refinancing challenges and eventually default. We last saw this type of bifurcation during the 2001 correction when the market downturn was focused on particular sectors (technology, telecom) and not systemic risk as was the case in 2009.

Since January 2015, Spread Widening has been most Pronounced in Energy and CCC rated Credits



Source: BofA ML.US HY BB (J0A1), US HY B (J0A2), US HY CCC (J0A3), US HY Energy (J0EN). As of February 11, 2016.

Valuations

US BB/B spreads have recently widened considerably. At 724 bps as of February 11th, 2016, they are close to their post-financial crisis wide of 783 bps (October 4, 2011) and have a bit more to go to get to their Dot Com wide of 909 bps (October 10, 2002). Of course, if one compares current spreads to their all-time wides of 1,692 bps at the height of the financial crisis (November 21, 2008), spreads have significant room to widen further. The key question becomes – does the market face systemic risk? One can never completely dismiss a crisis like 2008, but we believe the likelihood of another systemic collapse is small.

We believe the most useful way of looking at valuation is the implied default rate. Given current coupon and market prices (as of February 10), the US high yield market (J0A0) is pricing in an 8.0% default rate. The market is pricing in a 32.8% default rate for the energy sub-sector (J0EN). Ex-energy, the US high yield market is pricing in a default rate of 6.7%. We anticipate the default rate going forward ex-energy will be approximately 1% in 2016 (JP Morgan is forecasting 2% ex-commodities). Comparing the 6.7% priced into the market to the 1 to 2% anticipated default rate suggests current valuations are compelling. To provide some historical context, the high yield bond default rate for 2009 was 10.3%.[ii]

Muzinich Invests in BB/B Rated Credits; Significantly Underweight Troubled Basic Materials Sectors; We Do Not Hold Cocos or Structured Products

We have generally focused on quality (BB/B rated) credits in defensive sectors. We are significantly underweight energy and have virtually no exposure to CCC rated credits across our funds. We believe there will be a significant increase in defaults within the energy and metals/mining sectors as well as across CCC rated credits. We do not invest in Contingent Convertibles (CoCos). In keeping with our philosophy to only invest in securities we understand, we do not hold structured products. Derivative use is limited to our absolute return fund strategies and is generally used for hedging purposes only.

Is Now a Good Time to Invest?

Timing market bottoms is impossible. Given a variety of macro headwinds, we do believe we are in for a prolonged period of higher volatility. The main question we are thinking about is whether the risks to the corporate credit market remain contained to the basic materials sector and select CCC rated credits, or do problems in the banking system point to greater systemic risks.

Perhaps a bit of history might provide some interesting comparisons. We analyzed spread and returns for the US BB/B high yield market going back to the Dot Com crash of the early 2000s. If one had invested at any time when spreads for the US BB/B high yield market were wider than 600 bps – what would one's return have been two years later? The outcomes can be analyzed in a variety ways. However, what is most interesting is that since 2001, an investor has never lost money over a two year investment horizon if they bought into the market when spreads were over 600 bps. Total returns ranged from a minimum of 13.2% to a maximum of 75.9% with an average of 35.0%. Timing matters – but is very difficult to get absolutely right. What will matter over time are the fundamentals and credit selection. As today's implied default rate shows, investors with a reasonable investment horizon will likely be well rewarded.

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[i] **Financial Times, Short View, February 2, 2016.**
[ii] **JP Morgan Default Monitor, February 1, 2016.**