INSIGHT

Market Volatility and Rate Policy Normalization

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This recent correction was about rates, not fundamentals

Over the last few weeks, we have seen volatility return to global equity and fixed income markets. After peaking on January 26th, the S&P 500 with dividends declined -7.85%, while the US 10-year Treasury declined -2.25% (through April 24th). While tariffs and the threat of trade wars have certainly contributed to risk-off market sentiment, we believe this recent pullback in both US equities and fixed income is primarily a function of financial markets reacting to the prospect of rate policy normalization by the US Federal Reserve ("Fed"). Rate policy normalization refers to the steps the Fed is taking to raise short term rates to more normal levels and ultimately reduce the Fed's securities holdings currently on the balance sheet. At the same time, we believe the Treasury will need to increase its issuance given recent tax cuts and that this will likely translate into higher rates as the Treasury competes for funding from a shrinking buyer base. It is worth noting two things: 1) we saw a dispersion of returns within markets during this period with US equities, US 10-year Treasuries and investment grade corporates experiencing the sharpest declines compared to high yield bonds and leveraged loans; and 2) we believe the current correction was not a function of deteriorating credit fundamentals or a systemic crisis. As would be expected in an environment dominated by rate concerns, high yield and loans – with their strong coupon and shorter duration profile - better protected capital compared to US equities, 10-year Treasuries, and investment grade corporates. Despite outperforming each of these asset classes (except loans), high yield has seen multiple weeks of outflows – suggesting investors are punishing an asset class that has proven to be resilient in the face of rate increases and acts as a powerful portfolio diversifier.

Fed on path to normalize rate policy before cycle turns

With a bloated $4+ trillion balance sheet and a low Fed Funds rate, the Fed has limited monetary policy ammunition, at present, to combat the next recession. There is a sense that we are likely in the latter stages of the economic cycle and so a greater need for the Fed to act, especially since positive economic data and increasing inflation pressures provide numeric cover to normalize rates. The dot plots (member views on where Fed Funds rate should be at year-end) suggest that the US central bank will continue to raise rates throughout the year given supportive economic data.

Rising US deficits will likely put further upward pressure on Treasury rates

At the end of 2017, the Trump administration was able to pass its tax cuts, which according to the non-partisan Congressional Budget Office, is likely to increase the deficit in the coming years. Given the prospect of rising deficits, investors expect the Treasury will have to increase its issuance to meet the funding gap between tax revenue and government spending. This means that Treasury supply is likely to increase.

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 launch 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.

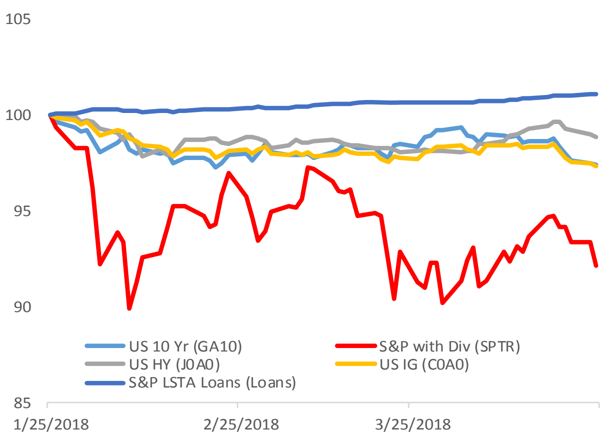
At the same time, demand for the asset class is likely to decline as certain buyers are anticipated to reduce their purchases. In its quest toward normalization, the Fed has committed to shrinking its balance sheet by allowing Treasuries that mature to roll-off without re-investing the proceeds. According to the Federal Reserve, we can expect to see a 35% reduction in the size of the Fed balance sheet over the coming three years. So the Fed, the largest buyer of Treasuries, will be buying less in the future. We believe foreign buyers are also expected to buy fewer Treasuries going forward as well. For example, Euro and Yen buyers face significant hedging costs that make holding Treasuries less economical. Finally – China – the single largest foreign holder of US Treasuries remains a wild card. It remains to be seen how far the US is willing to push in its trade war with this important US creditor.

Dispersion of returns – it's not all bad

A string of positive economic data and increasing inflation pressures led to a sell-off in Treasuries (price moves inversely to yield), investment grade and US equities as investors feared the Fed would move faster in its normalization drive. The US 10 year is now at 3%+ (as of April 24, 2018) - a yield last seen on a sustained basis in 2011.

Within fixed income, however, it was not all bad. We have noticed a dispersion of returns as high yield and loans, with their higher coupon and shorter duration profile have been able to better protect capital. As you can see in figure 1, loans are up over 1% since the January 26 market peak with high yield bonds only slightly negative as coupon income offset more than half of the price decline of the asset class. Unfortunately higher quality fixed income did not have sufficient coupon to offset most of the rate move, while equities in our view were revalued on higher discount rates.

Fig. 1 – Performance Since Market Peak – January 26th to April 24, 2018



Source: ICE BofA ML indices. US 10 Year – GA10, US HY – J0A0, US IG – C0A0. S&P 500 with dividends is SPTR.S&P LSTA Loan index.

High yield and loans not correlated to Treasuries

Conventional wisdom holds that in times of increased volatility and turbulence, asset class correlation converges to 1.00. That is, asset classes that are otherwise uncorrelated seem to decline in periods of market stress to a largely similar degree. The one exception to this rule is generally Treasuries that rally (yields decline) as investors seek safe havens. A close examination of recent data, however, tells a different story. Since January 26th, the only markets that are truly correlated (correlation greater than 0.70) are investment grade markets to Treasuries. Interestingly equities have a positive correlation to Treasuries (0.32) while US high yield and loans have a negative correlation to US Treasuries suggesting that US high yield and loans represents an attractive portfolio diversifier.

Fig. 2 – Correlation Table January 26th to April 24, 2018

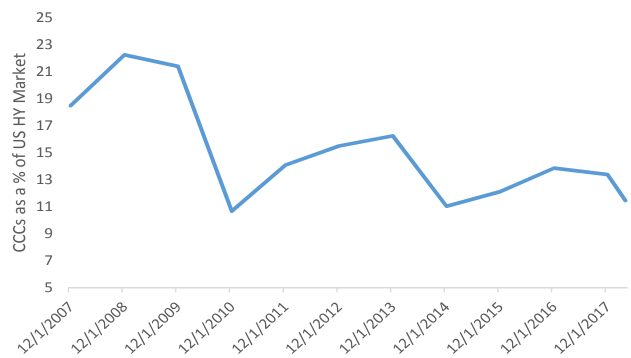
	US10 Yr	S&P 500	US HY	US IG	Loans
US 10 Yr	1.00	0.32	-0.03	0.92	-0.20
S&P 500		1.00	-0.20	0.25	-0.29
US HY			1.00	0.26	0.52
US IG				1.00	0.03
Loans					1.00

Credit fundamentals are strong

Is this the beginning of a recession? We emphatically say "no" as we do not see a return to excessive leverage and general economic data remains strong. According to JP Morgan, leverage declined for a 6th consecutive quarter while interest coverage ratios (a company's ability to make its contractual interest payment) are at a 2 year high.

Another important metric that highlights the improved quality of high yield is the percentage of CCC-rated bonds that make up the broad US high yield market. In early 2008 (January 31, 2008), 18.5% of high yield companies were rated CCC. As of April 25, 2018 that figure is 11.5%. Credit quality is actually better today (end of April) than before the recession despite being nine years into an economic recovery; the high yield market is being disciplined.

Fig. 3 – CCCs as a Percentage of the US HY Market (as of April 25, 2018)



Source: ICE BofA ML indices. US HY – J0A0, US CCCs – JUC3.

Dispersion of returns means active management matters

As we enter the latter stages of the economic cycle and stimulative monetary policy is withdrawn, we expect to see increasing dispersion of returns across high yield and loans. In such times, active management matters tremendously because issuers will compete for capital and certain issuers will be challenged with larger coupons or limited capital market access. An investor blindly buying the market via an index or a macro-oriented approach could be exposed to challenged issuers, while actively managed, fundamental credit portfolios, such as those managed by Muzinich, may avoid this disaster.

As we have demonstrated, high yield and loans have better protected capital in this recent market pull back. In today's environment, we believe high yield and loans act as a powerful portfolio diversifier. It is impossible to time markets. Given strong fundamentals and a solid coupon, we believe an allocation to high yield and loans is warranted in order to cushion market volatility. In this way investors will be paid to wait until there is greater visibility in rates.

Important information

Index definitions as follows:

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.

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.

J0A0 - 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.

JUC3 - ICE BofAML CCC and Lower US High Yield Constrained Index contains all securities in The ICE BofAML US Cash Pay High Yield Index that are rated CCC1 and lower, based on an average of Moody's, S&P and Fitch, but caps issuer exposure at 2%. Index constituents are capitalization-weighted, based on their current amount outstanding, provided the total allocation to an individual issuer does not exceed 2%. Issuers that exceed the limit are reduced to 2% and the face value of each of their bonds is adjusted on a pro-rata basis. Similarly, the face values of bonds of all other issuers that fall below the 2% cap are increased on a pro-rata basis. In the event there are fewer than 50 issuers in the Index, each is equally weighted and the face values of their respective bonds are increased or decreased

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.

S&P/LSTA Leveraged Loan Index – The S&P/LSTA Leveraged Loan Index is a market value-weighted index designed to measure the performance of the US leveraged loan market based upon market weightings, spreads and interest payments.

You cannot invest directly in an index, which also does not take into account trading commissions or costs. The volatility of indices may be materially different from the volatility performance of an investment. Historic market trends are not reliable indicators of actual future market behavior.