Viewpoint

Finding Value as the Momentum Fades

December 2018

As increasing macroeconomic and geopolitical risks lead to rising volatility, where do we see the main opportunities and challenges for credit markets in 2019?

As we entered 2018, global economic growth appeared healthy and synchronised. Against such a positive backdrop, the US Federal Reserve (Fed) had already started down the path of monetary policy normalisation and putting an end to quantitative easing, and other central banks looked set to follow suit.

However, as the year progressed, trade policy conflicts and geopolitical headwinds combined to weigh heavily on the global economy which slowed down notably during the second half of the year, concurrent with a peak in corporate earnings.

As 2018 draws to a close we are now in a very different position from a macroeconomic perspective. However, while risks have increased, we have not seen an abrupt halt to the economic cycle.

At this stage we believe the probability of the global economy falling into recession in the next 18 months is more of a tail risk event, rather than our base-case scenario. Nevertheless, the uncertainty around any forecast has risen due to several factors - some structural and some more cyclical.

Rising trade tensions between China and the US have increased uncertainties for corporates. In our view unilateral tariff decisions imposed on bilateral trade relationships appear to be a pattern that is here to stay. This sets up a very different framework for global trade, trade dispute resolution and global supply chains.

At the same time, global geopolitical risks have increased. While in isolation they would only have a marginal impact on credit markets, the combination of these tensions with the disruption to the global trade framework is creating an uncomfortable mix, which we believe could lead to sudden negative shocks on key market drivers such as commodities.

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Meanwhile a mixture of volatile equity markets, wider credit spreads, wider sovereign spreads in some countries and a persistent (albeit gradual) rise in US rates, has started to tighten financial conditions, not only in the US but globally.

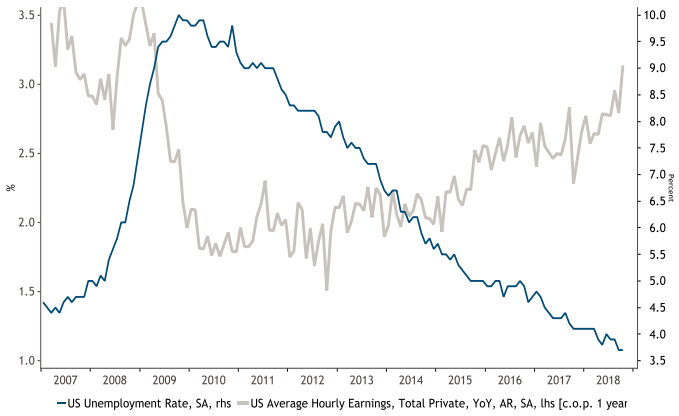
In our view, all the above arguments are currently acting as a drag on 2019 growth forecasts.

Monetary Policies in Normalisation Mode

A key factor for investors to assess in 2019 is the amplitude of monetary policy normalisation, in the US and more broadly.

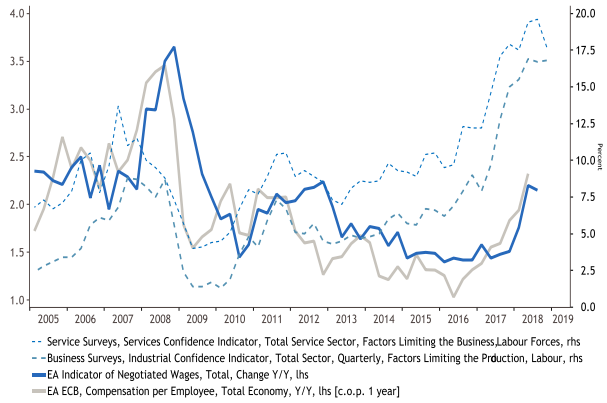
In our view, the global inflation response to elevated economic growth in 2017 was more conciliatory than expected. Further improvements in global employment over the last two years is now supporting wage increases in most developed economies, confirming the link between the labour market and wages has re-connected (Fig. 1, 2).

Fig. 1 – US Average Hourly Earnings and Unemployment Rate



Source: Bureau of Labor Statistics, as of 31 October 2018. SA – seasonally adjusted, AR – annualised rhythm, c.o.p. – change of period.

Fig. 2 – Euro Area Labour Shortage and Wage Evolution



Source: Eurostat, European Central Bank (ECB), Q3 2018, as of 31 October 2018. c.o.p – change of period.

How quickly this will feed into core goods inflation depends on many other factors such as corporate profit margins, global trade policies and their impact on domestic prices and foreign exchange rates, etc.

In the US, given the tight labour market, we see the inflationary risk in 2019 as asymmetric to the upside. Moreover, we are not seeing any labour productivity improvement, which would usually be expected at this stage of the cycle. Persistently low oil prices could delay the inflation response, but the trend should remain positive and should call for further adjustments in US short rates.

We expect several changes in the US monetary policy framework in 2019.

In an important speech at the Economic Club of New York on 28th November, Chair Powell said that current levels of interest rates were "just below the broad range of estimates" of neutral rates.[1] Since then, markets have removed almost all hikes that were expected for 2019. However, in our view the US macro picture is not weak enough to prevent the Fed from further hikes and we would expect two to three more before the Fed pauses.

In addition, Chair Powell seems to have somehow removed the forward guidance tool as the Fed approaches its neutral rates level. This should introduce more volatility into the short rates forward curve as the market is unlikely to look through the short-term volatility of macro data.

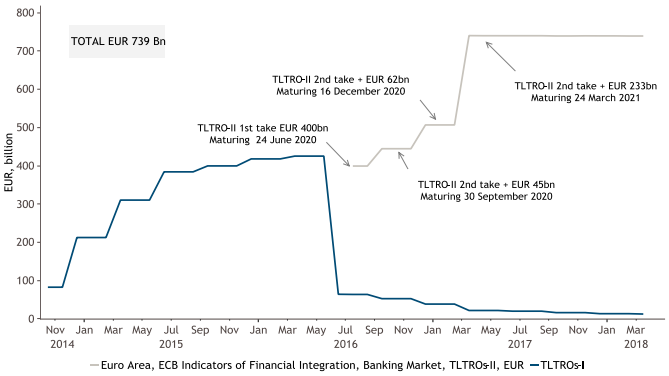
While the Fed seems ready to be flexible on its rates path debate, it is not currently discussing the rhythm of the reduction of its balance sheet. The forecast of annual shrinkage is equivalent to US$600bn on a fully annualised basis for 2019, which is maintaining some pressure on the total supply of Treasury bonds and long rates.[2]

Meanwhile central banks from other developed economies are also now engaged, or very close to, with their own monetary policy normalisation plans.

The European Central Bank (ECB) is expected to stop its net buying of sovereign and corporate debt by the end of 2018. The next step, according to the ECB, would be to raise interest rates by the end of summer 2019.[3] We believe this calendar-based enhanced forward guidance is rare from the ECB and contrasts with the Fed's approach, and is aimed at keeping the forward rates curve anchored.

The expiration of the current targeted longer-term refinancing operations (TLTROs) of €739bn, due to mature from March 2020 to March 2021, and which has been very supportive for the European banks, is also an issue that we believe the ECB is soon likely to address. In our opinion, the ECB is likely to propose new long-term refinancing operations (LTROs) somewhere in the second quarter of 2019 to ensure a smooth transition with the existing TLTROs and enable the banks to meet their net stable funding ratio (NSFR) (Fig. 3) .[4]

Fig. 3 – ECB's Existing LTRO Programme



Source: ECB, as of 30 November 2018.

1. https://www.federalreserve.gov/newsevents/speech/powell 20181128a.htm
2. https://www.federalreserve.gov/monetarypolicy/files /fomcminutes20180613.pdf
3. https://www.ecb.europa.eu/press/pr/date/2018/html/ ecb.mp180614.en.html
4. https://www.ecb.europa.eu/mopo/implement/omo/html/ index. en.html

In our view, the combination of central bank balance sheet normalisation, modest inflation progression and higher short rates in major funding currencies should ensure investors' appetite for low duration and/or inflation protection strategies remains intact.

Credit Markets - Fundamentals Downgraded but Valuations have Improved

Since mid-2016, we believe diversified investors have been exposed to 'momentum' trades – betting on the strength of the global economic cycle and designing portfolios to benefit accordingly. The result was a large overweight in equity markets, often financed via fixed income.

In credit markets, macro strength assumptions supported high yield outperformance over investment grade, strong performance from CCC rated bonds versus BBs and cyclicals over defensives.

However, 2018 has been a year where disruptive tail risks emerged such as trade wars and US monetary tightening, Brexit and the Italian budgetary issues in Europe, and crises in Turkey and Argentina in emerging markets, which weighed on these positions.

While February-to-June setbacks were an opportunity to add equity/high yield exposure at cheaper levels, the October - December sell-off appeared in our view to be the result of much deeper fundamental concerns on late-cycle investing and negative credit migration risks. Combined with poor liquidity around year end, price action has been large and volatility elevated. Cash has been raised and does not seem to have yet been reinvested.

Looking ahead, we believe the significant fourth quarter sell-off has changed the return expectations for 2019 and we could see a shift further away from momentum trades towards value/income trades, given the more attractive valuations.

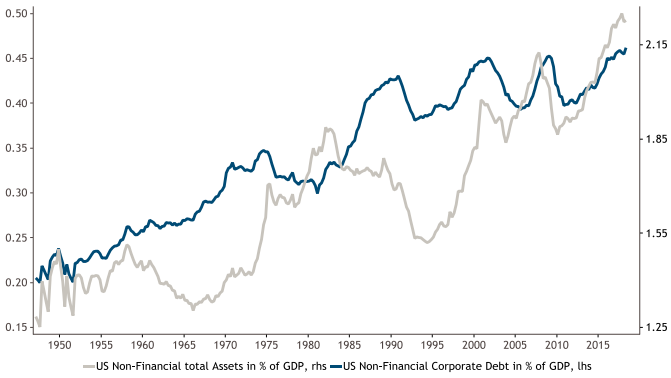
In our opinion, high yield can again compete with equities, in particular in risk-adjusted terms; absolute yields have reached levels not seen for many years (see Fig.9, overleaf).

With better valuations and softer global growth, but no recession likely next year, we believe the case for balanced portfolios to reconsider their credit allocation appears more compelling than at any time during 2018.

Fundamentals – the Focus on Investment Grade BBB

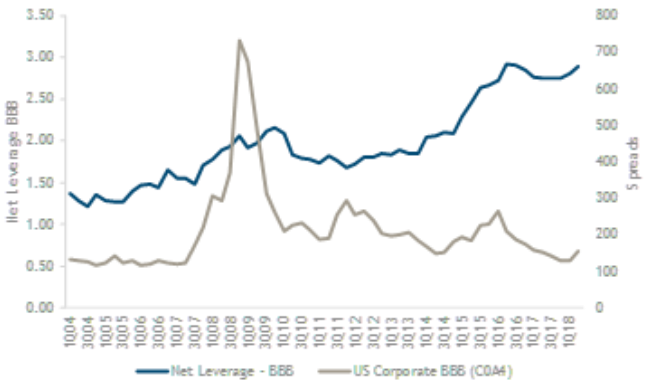
The fundamental backdrop evolved notably in 2018, particularly in the US. Overall, US non-financial debt increased (Fig. 4), as did leverage ratios in investment grade credit (Fig. 5).

Fig. 4 – US Non-Financial Corporate Debt and Assets as a % of GDP



Source: Federal Reserve, as of 30 June 2018.

Fig. 5 – Rising Leverage in US Investment Grade



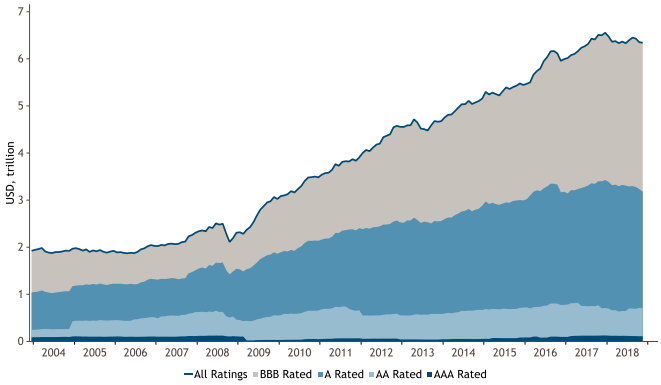
Source: Net Leverage – JP Morgan. Spreads are ICE BofA ML BBB US Corporate Index (C0A4). As of June 30, 2018. The latest net leverage figures are only available as of June 30, 2018.

The current concerns are less about high yield market leverage ratios, and more about investment grade.

The overall market cap of the US investment grade market stabilised in 2018 after several years of significant growth (Fig. 6).

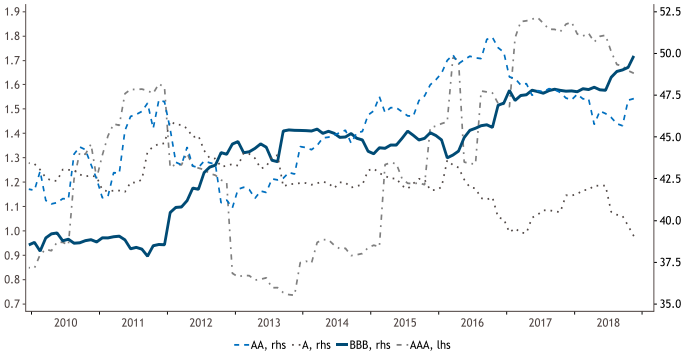
However, this is not true for the BBB rated segment which continued to grow materially in absolute dollar terms and relative to other ratings segments within the investment grade sphere (Fig. 7, overleaf).

Fig. 6 – Evolution of US IG Corporate Market Cap



Source: ICE BofAML US Corporate Index (C0A0), ICE BofAML AAA US Corporate Index (C0A1), ICE BofAML AA US Corporate Index (C0A2), ICE BofAML Single-A US Corporate Index (C0A3), ICE BofAML BBB US Corporate Index (C0A4), as of 30 November 2018.

Fig. 7 – Evolution of Ratings Segment as % of Total Market Cap



Source: ICE BofAML US Corporate Index (C0A0), ICE BofAML AAA US Corporate Index (C0A1), ICE BofAML AA US Corporate Index (C0A2), ICE BofAML Single-A US Corporate Index (C0A3), ICE BofAML BBB US Corporate Index (C0A4), as of 30 November 2018.

Significant downgrades from A to BBB (around $170bn year to date 2018, $83bn quarter to date to end October) occurred in 2018 despite strong economic growth, mainly because of increased leverage associated with M&A deals and debt issuance to finance share buybacks.[5]

In addition, according to JPMorgan the BBB leverage ratio in the second quarter rose by a multiple of 2.9 for the all-sectors index and a multiple of 2.6 for the BBB segment ex. energy, metals & mining and utilities.[6]

This is back to levels seen in the second quarter of 2016, a direct reflection of downgrades from A, but also leverage trending higher for core BBB companies in 2018. Moreover, even after the recent spread widening, the spread per turn of leverage at 60bps is less than that of 100bps in the first quarter of 2016, or out to 170bps by the end of 2011.[7]

The fear of market participants comes from the current size of the BBB non-financials segment ($2.4trn) that could suffer from further negative credit migration, compared with the size of the high yield market ($1.2trn), and more specifically the BB segment ($570bn).[8]

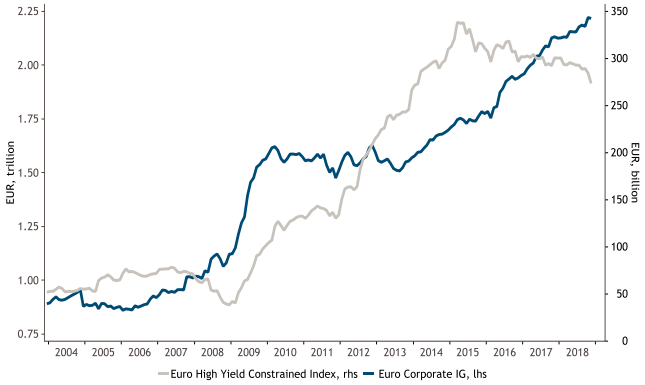
We would moderate these concerns however as the BBB- non-financials segment represents "only" $736bn, of which Goldman Sachs estimates $164bn are under negative watch, and of which $10bn have a more severe downgrade watch status.[9]

Moreover, for such a cataclysm to materialize, and despite these quite alarming numbers, corporates would need to ignore the current market message and continue to increase leverage, or for a severe revision to economic growth to hit current forecasts. Although this remains a risk, it does not form our base-case scenario.

The European investment grade market is not immune from investor concerns. The growth of this segment has been rapid, boosted by the ECB's quantitative easing programmes and heavy issuance policies from corporates benefiting from private investors shifting away from government bonds into investment grade rated corporate bonds. Here too, the contrast between the growth of the European investment grade market and the shrinkage of the European high yield market is notable (Fig. 8).

5. Goldman Sachs - The Credit Trader, Nov 8, 2018
8. JP Morgan - High Grade Credit Fundamentals: 2Q18, Aug 24, 2018
7. Ibid.
8. ICE BofA ML BBB US Corporate Index (C0A4), ICE BofA ML BB US High Yield Constrained Index (HUC1) as of 30 November 2018
9. Goldman Sachs - The Credit Trader, Oct 25 2018
10. – Source: Bloomberg, ISTAT, Italy Q3 GDP -0.1%, Bloomberg, Germany Federal Statistical Office – German Q3 GDP -0.2%

Fig. 8 – Market Cap Evolution for EUR Credit IG and HY



Source: ICE BofA ML Euro Corporate Index (ER00), ICE BofA ML Euro High Yield Constrained Index (HEC0), as of 30 November 2018.

While the end of the ECB's quantitative easing programme is certainly not a recent issue, it continues to be a source of concern as the negative net outflows in euro-denominated credit funds during the fourth quarter would suggest.

In addition, weakness of the economic cycle has surprised on the downside this year. In our opinion, Germany may experience a "technical recession" in the second half of 2018 and Italian economic growth has almost stalled over the same period. [10]

The geopolitical environment is also often quoted by investors as a reason to be underweight European credit. At the time of writing, the Italian debate around the 2019 budget seems to be moving towards a compromise from both sides, removing a broader risk of contamination for European government bonds, although the Brexit evolution remains highly uncertain.

Nevertheless, we believe there are several factors that could prove positive for European credit going forward.

Private sector demand in the euro area appears very solid, with improving employment solidifying private consumption, while public and private investment spending remains resilient.

We believe the ECB's policy to fully reinvest all proceeds from coupons and redemptions, at least until rates have started to normalise (which at best would be at the end of 2019), is an underestimated positive by market participants. The possible new LTRO programme should also remove some pressure from banks' issuing programmes next year.

The fundamental outlook for emerging economies is expected to contrast with advanced economies and improve in 2019, provided that US rates are not raised beyond reason and that the US dollar remains stable or weakens.

Beyond the idiosyncratic situation in countries that ignored the tightening financial conditions for too long and maintained an inadequate policy mix (Argentina, Turkey), we could see Brazil and Mexico benefiting from lower political risk premium and more market-friendly policies.

While Asia may face the risk of a further slowdown in the Chinese economy, our central scenario is that the very extensive growth stimulus programmes put in place by the Chinese leadership may ultimately offset the negative impact of the trade tariffs imposed on Chinese exports to the US.

While we have maintained our Fundamentals scoring at elevated levels for most of 2018, and while we do not expect the default rate to rise materially next year, we would expect our average score on Fundamentals to be reasonably lower in 2019, certainly closer to neutral (see Fig.11 at end of document).

Fig. 9 –Variations of Yields and Spreads by Asset Class

	Spreads to Worst Bps		Yield to Worst % (local)		Yield %
	2 January 2018	4 December 2018	2 January 2018	4 December 2018	Hedging in EUR or USD
US 2y	-	-	1.92	2.79	-0.46 (EUR)
US 10y	-	-	2.46	2.91	-0.34 (EUR)
Bund 2y	-	-	-0.61	-0.61	2.64 (USD)
Bund 10y	-	-	0.46	0.27	3.52 (USD)
US IG BBB	125	184	3.63	4.78	1.53 (EUR)
US HY	362	436	5.77	7.21	3.96 (EUR)
US Loans	416	449	6.55	7.28	4.03 (EUR)
European Loans	392	414	4.11	4.40	7.65 (USD)
Euro IG BBB	102	190	0.97	1.68	4.93 (USD)
Euro HY	275	480	2.47	4.55	7.80 (USD)
EM Corporate IG	133	198	3.35	4.52	1.27 (EUR)
EM Corporate HY	339	522	5.56	8.00	4.75 (EUR)
EUR/USD Hedging Cost	-	-	2.24	3.25	-

Source: Bloomberg, BofA Merrill Lynch. ICE BofA ML US 2-Year Treasury Index (US 2y), ICE BofA ML US 10-Year Treasury Index – GA10 (US 10y), ICE BofA ML 2 Y-Year German Government Index (Bund 2 Yr), ICE BofA ML 10-Year German Government Index (Bund 10 Y), ICE BofA ML BBB US Corporate Index – C0A4 (US IG BBB), ICE BofA ML US Cash Pay High Yield Index – J0A0 (US HY), S&P/LSTA Leveraged Loan Index (US Loans), S&P/LSTA Leveraged Loan Index (European Loans), ICE BofA ML BBB Euro Corporate Index – ER40 (Euro IG BBB), ICE BofA ML Euro High Yield Index – HE00 (Euro HY), ICE BofA ML High Grade Emerging Markets Corporate Plus index – EMIB (EM Corporate IG), ICE BofA ML High Yield Emerging Markets Corporate Plus index – EMHB (EM Corporate High Yield), EURUSD (EUR/USD Hedging Cost), as of 30 November.

Valuations – Wider Spreads But is it Enough?

Tight valuations were often quoted as the main reason for underweighting credit in balanced portfolios. While equities were more appealing than credit during the first half of 2018, the situation changed dramatically during the second half as credit sold off. The resultant attractive valuations in credit markets could compete better relative to other asset classes in 2019.

Credit spreads widened markedly in 2018 (Fig. 9). In the US, higher US government bond yields have amplified the impact on all-in yields.

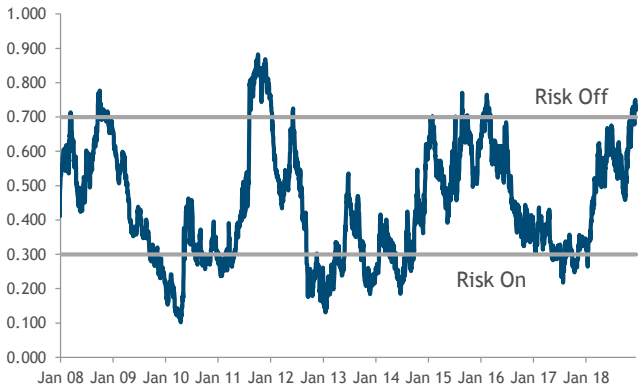
These moves are the sharpest since 2015, and the levels reached are similar to those witnessed in the summer of 2016, where the macro cycle was starting to strengthen.[11]

The yield to worst (YTW) on European investment grade BBB bonds (ER40) has doubled in one year to 1.66%, while the YTW on European high yield (HEC0) has more than doubled to 4.4%.[12] The US investment grade BBB market (C0A4) is now yielding 4.75%, 150bps more than in mid-2016, while US high yield (J0A0) reached 7.30% by late November.[13]

According to our Z-score calculations on the asset classes we follow, all have risen to levels which suggest that valuations have again reached what we believe to be attractive levels, both in investment grade and high yield. In parallel, our global market risk appetite indicator has reached stress levels last seen during the massive sell off at the end of 2015 and during the crisis period in late 2011 (Fig. 10).

11. Source: ICE BofA Merrill Lynch credit indices.
12. Source: ICE BofA Merrill Lynch BBB Euro Corporate Index (ER40), ICE BofA ML Euro High Yield Constrained Index (HEC0), as of 30 November 2018
13. Source: ICE BofA ML BBB US Corporate Index (C0A4), ICE BofA ML US Cash Pay High Yield Index (J0A0)

Fig. 10 – Muzinich Risk Model



Source: Muzinich, Emerging Market Research, as of 21 November 2018.

Meanwhile, cross currency hedging costs between the US and Europe will likely remain on an upward trajectory if the Fed continues its rates normalisation policy.

While the bullish momentum of the US dollar has helped some investors invest unhedged in US assets in 2018, such a bet may appear less rewarding in 2019 given the persistent widening of the US twin (i.e. fiscal and current account) deficits, combined with economic growth convergence between the US and the rest of the world in 2019-2020.

The hedging cost benefit for US dollar based investors comes with a hidden gift - low volatility. In a less predictable environment, we believe such a gift is worth a considerable amount for US dollar based investors. However, these hedging costs are also an obstacle for euro or Japanese yen based investors to invest in US dollar-denominated assets, a hurdle that may keep European savings in domestic markets.

The significant repricing of emerging market credit started in May 2018. Heavy supply, combined with trade war concerns, hit emerging market debt at cycle tights throughout the summer.

In our view, the recent correction preserved the asset class in relative terms to US or European credit. Nevertheless, spreads continued to widen to levels that many would consider attractive.

Once the Fed's outlook stabilises, the emerging market corporate market may well appear as one of the main beneficiaries of the search for yield. With superior yields on short duration instruments (5.86%), we believe valuations already appear to be quite attractive.[14]

However, if credit market valuations have reached more comfortable levels, investors are likely to question whether this is enough to compensate them for the risks ahead, particularly the risk of recession.

For new valuations to be attractive enough to investors, we believe spreads have to compensate them for two factors of uncertainty - the economic cycle and higher volatility - and to provide a premium versus other asset classes.

We remain reasonably confident that the economic cycle still has some strength and that a recession could be prevented. We believe the current spreads have integrated higher volatility during the last few weeks. Meanwhile, the relative value argument has evolved in favour of credit markets but possibly not enough to rejuvenate investor demand just yet. Nevertheless, we can see conditions for this happen in 2019.

Technicals

Technicals (supply and demand dynamics) have been very different from one region to another.

The US high yield market has been notoriously undersupplied this year (-25% of net issuance versus 2017 YTD). The investment grade market was well supplied in the first half of the year, but has been less so during the more volatile second half. [15] At the same time, the loan market has been a funding alternative for corporates in the high yield space with a net issuance of US$434bn over the year. [16]

The supply profile of the European corporate credit markets has been different. As mentioned above, corporates have benefited from the ECB's corporate sector purchase programme (CSPP) by issuing CSPP eligible bonds. This has resulted in a significant growth of the European investment grade market. Most of this growth has come from BBB rated companies, a similar pattern to the US. In our view, the rise of US yields has not however encouraged other investment grade issuers to issue longer-dated paper as they have in previous years.

The average duration of the US BBB segment has declined marginally from 7.2 years to 6.9 years.[17] This is very similar for the European investment grade market, where average duration has declined from 5.2 to 4.9 for an equivalent BBB rating.[18]

The opposite trend is evident in high yield, where average duration rose by half a year for both US and European high yield, as a result of fallen angels from the BBB segment.[19]

What has made a significant difference in 2018 has been on the demand side where outflows have hit all credit markets – investment grade and high yield across the US and Europe.

14. Source: Bloomberg, ICE BofA Merrill Lynch Emerging Market Short Duration Custom Index (Q690) at 5.86% YTW as of 11 December 2018
15. Source: ICE BofA ML US Cash Pay High Yield Index (J0A0), ICE BofA ML US Corporate Index (C0A0), as of 30 November 2018
16.Source: Deutsche Bank Global Credit ChartBook, S&P LCD US Loans Index, as of 30 November 2018
17. Source: ICE BofA ML BBB US Corporate Index (C0A4), as of 30 November 2018

If these technicals have been a clear negative all year long, it also means that the 'tourist' money – aimed at opportunistically capturing yields during heavy cash inflows linked to central bank quantitative easing programmes - have progressively shifted away from these investments and moved back to equities or core fixed income.

Fourth quarter 'capitulation' outflows in particular could be a signal for investors to start repositioning portfolios. We notice that institutional investors, remarkably absent during the various hiccups this year, appear to be contemplating valuations with more appetite, in particular vis-a-vis the equity market.

Equity allocations are likely to keep investors' attention as we enter 2019, but we believe the extreme positioning seen this year in favour of equities is unlikely to be replicated in 2019.

The Return of Value in 2019

We believe that the mix of more attractive valuations in credit markets, combined with a 'Goldilocks' scenario (i.e. not too hot or too cold) for the global economy in 2019 could reinvigorate institutional and retail demand for credit, particularly in high yield.

However, in our view, for such interest to manifest itself into significant inflows, the current macroeconomic uncertainties have to dissipate, namely trade wars and the inflection point in US monetary policy tightening.

As we outlined last year, the hedging cost between the US dollar and euro has climbed notably in 2018, reflecting the divergence in monetary policies between the two continents. We believe these hedging costs are unlikely to improve in 2019 and should therefore continue to impact global investment strategies.

With the direction of US growth less predictable in 2019 than in 2018, there is no longer any consensus on the direction of the dollar, something that we expect could prevent investors remaining open to exchange rate risk in 2019.

The prospect of further US rates tightening in the near future should be positive for US loans markets.

High margins and low volatility are arguments that also play in favour of loans for euro-denominated portfolios. Nevertheless, deteriorating fundamentals require us to be very discerning in issuer selection to enable us to aim to deliver positive returns in 2019.

Our investment team were reasonably comfortable with fundamentals and default rates in 2018, although found tight valuations unattractive. In our view, 2019 is likely to be a sharp contrast.

Fundamentals will have to reflect lower macroeconomic prospects, their impact on profits and average leverage ratio and higher political risks.

However, we believe Valuations should have reached a point in early 2019 that will be difficult to ignore and reinforce the prospects of achieving interesting positive absolute returns, in particular within higher-yielding credits.

Technicals should turn more positive but we believe some macroeconomic uncertainties have to be removed during the first quarter of 2019 for this to happen.

After quite a disruptive 2018, in our view 2019 may well see the return of value trades for global credit markets.

18. Source: ICE BofA ML Euro Corporate Index (ER00), as of 30 November 2018
19. Source: ICE BofA ML US High Yield Index (H0A0), ICE BofA ML Euro High Yield Constrained Index (HEC0), from 30 November 2017 to 30 November 2018

Fig. 11 – Fundamentals, Valuations and Technicals for Global Credit

	US		Euro		EMD	
FUNDAMENTALS	0	0	1	1	1	1
	+ Still robust domestic macro picture in 2019 with strong Q3 earnings results. Trade wars raising concerns though + Lower leverage in HY and IG, low default rate outlook - Fed persistent tightening and peak in profit margins in 2019. - Low oil prices not favourable to energy sector - Loans: less positive fundamentals		+ Corporate earnings cycle still positive + Low default rate in HY - Growth momentum slowing down - Political risk (European elections), fiscal (2019 budget plans) and macro (Italy growth stalling) - End of QE confirmed for end of 2018 - Brexit risk still fluid situation		+ Gross corporate debt stabilising with EBITDA trend recovering after 2018 results + Financial conditions index stabilising in 4Q18 + Global emerging macro stabilising in 2019 with less inflation risk - Geopolitical/US trade policy risk - Persistent FOMC interest rate policy and USD (if beyond expectations)	
VALUATIONS	2	1	1	2	2	2
	+ 2018 correction going deeper than fundamentals justify, provides better valuations in all rating segments + Z Scores show much better value + Loans still attractive hedge vs. higher rates/yields and better valuations after Q4 correction, interesting carry - Market sentiment still poor as liquidity dried up		+ 2018 correction going deep, underperforming US, creating relative value, especially hedged back into USD + Much more dispersion opportunities as market repriced strongly in 4Q18. - ECB end of QE - Idiosyncratic disappointment leads to "gappy" market and poor liquidity		+ Resilience in 4Q18 proves spread levels have priced a lot of negatives + Recent sell offs increased value across EM countries beyond actual risk - High beta names suffering from high volatility	
TECHNICALS	-2	0	-2	-1	0	0
	+ Undersupplied in IG and HY bonds market still the case in 2019, high supply in Loans matched by strong demand (institutional and CLO) - Hedging costs for non-USD based investors increasing materially - Structural UW credit in global/US portfolio - Still outflows in HY		+ Hedging costs for USD based investors >3.25% - Outflows maintained in November in capitulation Lack of institutional demand which still OW equity Equity volatility still elevated - Quality of new issues – weak covenants		+ EMD flows have been very resilient through the Oct-Dec sell-off. Undersupplied market after 2H18 ultra-light supply - "Tail risk" vehicle, higher volatility - Vulnerable to higher US rates volatility	

Key: IG HY

Source: Muzinich & Co. As of 12 December 2018. Scale runs from -3 (worst rating) to +3 (best rating).
Internal calculations. Results of Muzinich's investment team's appreciation of different economic and statistical data such as economic cycle, leverage, interest coverage ratios etc.

Please see Important Information overleaf.

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Index Descriptions

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.

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.

Important Information

HE10 – The ICE BofA ML BB Euro High Yield Index is a subset of the ICE BofA ML Euro High Yield Index (HE00) including all securities rated BB1 through BB3, inclusive.

HE20 – The ICE BofA ML Single-B Euro High Yield Index is a subset of the ICE BofA ML Euro High Yield Index (HE00) including all securities rated B1 through B3, inclusive.

HUC1 – The ICE BofA ML BB US High Yield Constrained Index contains all securities in the ICE BofA ML US High Yield Index (H0A0) that are rated BB1 through BB3, based on an average of Moody's, S&P and Fitch, but caps issuer exposure at 2%.

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.

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

G1D0 – The ICE BofA ML German Federal Government (1-3 year) Index is a subset of the ICE BofA ML German Government Index (G0D0) including all securities with a remaining term to final maturity greater than or equal to 1 years and less than 3 years.

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.

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.

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

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.

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.

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

Important Information

ICE BofAML US Corporate Index (C0A0) ICE BofAML 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. Original issue zero coupon bonds, 144a securities (with and without registration rights), and pay-in-kind securities (including toggle notes) are included in the index. Callable perpetual securities are included provided they are at least one year from the first call date. Fixed-to-floating rate securities are included provided they are callable within the fixed rate period and are at least one year from the last call prior to the date the bond transitions from a fixed to a floating rate security. Contingent capital securities ("cocos") are excluded, but capital securities where conversion can be mandated by a regulatory authority, but which have no specified trigger, are included. Other hybrid capital securities, such as those issues that potentially convert into preference shares, those with both cumulative and non-cumulative coupon deferral provisions, and those with alternative coupon satisfaction mechanisms, are also included in the index. Equity-linked securities, securities in legal default, hybrid securitized corporates, eurodollar bonds (USD securities not issued in the US domestic market), taxable and tax-exempt US municipal securities and DRD-eligible securities are excluded from the index.

ICE BofAML AAA US Corporate Index (C0A1) ICE BofAML AAA US Corporate Index is a subset of ICE BofAML US Corporate Index including all securities rated AAA.

ICE BofAML AA US Corporate Index (C0A2) ICE BofAML AA US Corporate Index is a subset of ICE BofAML US Corporate Index including all securities rated AA1 through AA3, inclusive.

ICE BofAML Single-A US Corporate Index (C0A3) ICE BofAML Single-A US Corporate Index is a subset of ICE BofAML US Corporate Index including all securities rated A1 through A3, inclusive.