Capital at risk. The value of investments and the income from them may fall as well as rise and is not guaranteed. Investors may not get back the full amount invested.

2022 Outlook

Time to Harvest Carry

December 2021

While risks remain, we expect the global economic momentum to continue into 2022, creating a potentially positive backdrop for credit

Michael McEachern, MBA
Portfolio Manager, Co-Head of Public Markets and Co-Head of the Asset Allocation Group

Tatjana Greil Castro, Ph.D.
Portfolio Manager & Co-Head of Public Markets

Erick Muller
Director, Product and Investment Strategy and Co-Head of the Asset Allocation Group

This material is not intended to be relied upon as a forecast, research, or investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The opinions expressed by Muzinich & Co. are as of December 2021 and may change without notice.

Executive Summary

Global Macroeconomic Backdrop

- We expect economic growth to continue to hold above potential in 2022 in advanced economies and to slow down in developing economies versus 2021. We expect inflationary pressures to decline somewhat in early 2022 but not far or fast enough to relax tensions at the short end of the curve.

Rates

- We believe the Federal Reserve is likely to start to raise interest rates by mid-2022 at the earliest, while it could take up to the end of 2023 for the European Central Bank to be fully prepared to raise interest rates. Emerging market central banks have already started to rate hikes and most of these policy actions will mature in 2022. We expect real yields to move up in 2022, pushing nominal rates higher as well. The long end of the curve should be well anchored in the process, which may flatten the long end of the curve slightly further while the short end may steepen further.

Duration

- While we maintain our preference for credit risk over duration risk from a structural standpoint, there is room for a more tactical approach to duration management in flexible portfolios. Our view for barbell strategies, duration wise, reflects our perception of significant uncertainties surrounding Covid-19, inflation's slow deceleration and the reaction function of central banks. We expect a high volatility environment in government bond markets to persist in 2022.

Credit

- Fundamentals - corporate credit fundamentals peaked in 2021 from the low point of Q2 2020 after the start of the pandemic, but remain robust with sound balance sheets within a robust earnings cycle. Defaults remain low and net leverage has improved. Positive credit migration continues to be a tailwind, especially for high yield.
- Technicals – expected to improve in 2022 with lower net supply likely, especially in high yield. The demand for short duration floating rate instruments should also continue. In addition, we expect a continued increase in the issuance for ESG-related bonds in high yield and investment grade.
- Valuations – even after the November 2021 widening, credit spreads remain historically tight. However, the strong credit metrics and the search for yield may keep credit spreads within a range similar to Q4 2021.

Portfolio Positioning

- We believe 'carry will continue to be king' in 2022. Against expectations of continued global growth, investors are likely to keep overweight in risk assets and buy-on-the-dip, provided severe lockdowns can be avoided. Our preference for carry means keeping the 2021 overweight in high yield through the first part of 2022.
- Current valuations and Covid-19 uncertainties suggest keeping a quality bias when investing in high yield as cash flow generation will be the focus to generate low volatility carry. We see an interesting relative value proposition in European high yield when incorporating foreign exchange hedging costs.
- Securitized credit, leveraged loans and private debt investments should see high demand, all floating rate instruments offering higher carry and lower volatility versus bonds. They are also expected to contribute nicely to enhancing the Sharpe ratio of portfolios.
- From a sector allocation standpoint, we like a combination of commodity producers, selective reopening/cyclical sectors which have some value left, and some defensive sectors with reasonably high cashflow generating power.
- Our portfolios are likely to continue to have exposure to bank subordinated debt. Banks are likely to benefit from a normalisation in rates and steeper curves. Bank balance sheets also appear healthy despite the severity of the recent pandemic-induced recession. We keep a positive opinion on diversified financial senior debt.
- We require better valuations to resume an overweight in corporate subordinated bonds.

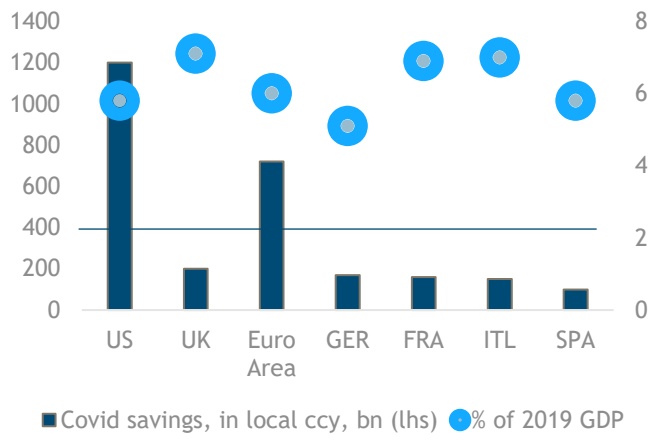
Introduction

Developed economies are emerging from one of the most severe recessions in history, one with little comparison to previous crises. However, in terms of how the economic situation has impacted corporates, we believe private sector balance sheets are very sound at this stage of the cycle.

Corporates repaired their balance sheets during the downturn, and this has led to strong credit metrics with a robust earnings/profitability cycle as economies reopened and economic activity surged.

Meanwhile workers have benefited from historic governmental financial transfers to mitigate the pandemic-induced destruction of demand and, in aggregate, currently show an excess savings accumulation in the region of mid-single-digit percentage of GDP. [1]

Fig.1 - Pandemic-Related Excess Savings in Local Currencies and in % of Respective GDP



Source: DB research: Consumer spending pent-up demand survey Oct 21, Olga Cotaga and Luke Templeman, as of November 2021.

Banks' balance sheets are healthy, benefiting from strong provisioning early in the crisis and a low level of defaults in their lending portfolios. In most jurisdictions, banks have benefited from exceptional monetary and regulatory policy measures to preserve lending capacity during the pandemic. Dramatic misses in forecasting (possibly Covid-19 related) or large mistakes in policy execution would be needed to modify those findings through 2022.

When assessing the future balance of demand and supply, we expect demand to remain robust for an extended period. Business expectations are upbeat, and order books full. Meanwhile demand for labour is not matched with adequate supply, which is leading to higher wages and disposable income.

Expansionary fiscal policy cannot just stop here and a general return to austerity, as we witnessed in the last cycle, in our opinion does not seem likely. Any negative fiscal impact would cancel all benefits of the careful management of the impact of the pandemic.

Risks do however appear to be coming from the supply side where many factors are at play, some temporary, other less so. It may take longer for fluid supply chains to return, and they may not come back in the same form anyway. Fully globalised supply chains were vulnerable during the pandemic.

Rising geopolitical tensions are adding to the demand for the reorganisation of supply chains, which may extend the cap on production capacity. Deficient business capital expenditure over the last decade may reverse, according to recent data,[2] but would not help to ease immediate supply issues.

Due to Covid-19, the likelihood of further lockdowns remain a risk, this requires the market to price a premium from the tight levels seen at the beginning of Autumn 2021. On balance for 2022 however, there appears more risk of an extension to the current imbalanced supply/demand situation than a dramatic loss of economic momentum.

Developed Markets

The corollary of this situation is twofold. Inflation risk is higher than central banks admit. Some factors behind price surges are transitory in nature, such as energy. Others are longer lasting such as supply chain disruptions, while some could be more resilient such as housing costs, the structural reorganisation of supply chains, inefficient job markets, the impact of climate change on food prices and the cost of energy in the transition away from fossil fuels.

While the direction of inflation is difficult to predict, we admit this, it could last longer and run higher than the tolerance embedded by the monetary policy frameworks of developed markets.

To avoid a credibility risk of these new monetary policy frameworks, policy rate tightening may be warranted sooner rather than later. This has been well incorporated by many emerging countries, where policy rate adjustments have already taken place, sometime forcefully, but was less likely to be delivered as needed for the advanced economies.

However, we take note of the recent shift in the Federal Reserve's (Fed) narrative, ending the seeming denial of inflationary pressures and validating the market's pricing a start to 'lift-off' by the second half of 2022.

[1] DB research as of November 2021. Consumer spending pent-up demand survey Oct 21, Olga Cotaga and Luke Templeman
[2] Institute for Supply Management, IHS Markit Purchasing Manager Indices, 31st October 2021

The eurozone economic cycle is often considered to be almost two years behind the US, and therefore inflation risks are less acute. However, this seems a fragile argument regarding the current cycle as the shock of the pandemic, its consequences and policy responses, were coincidental to both economies, and very similar in nature.

Nevertheless, the diversity of the pandemic measures implemented by the ECB requires a different sequencing in the normalisation of monetary policy than the Fed. These various measures cannot be withdrawn simultaneously without tightening financial conditions beyond what can be economically tolerated. Therefore, we believe the exit of ultra-loose monetary policy will hardly be synchronised between the Fed and the ECB.

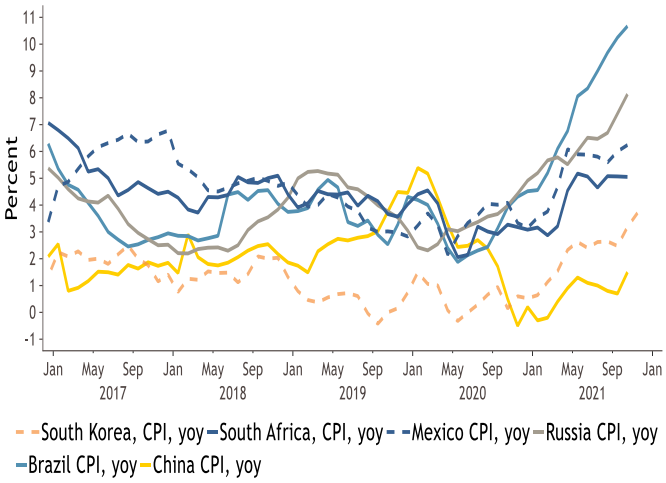
Emerging Markets

There is more dispersion in emerging economies with different policy mix cycles at play within emerging markets (EM). Different dynamics are at play in the emerging world, and this is unlikely to stop in 2022.

The social consequences of the often-mediocre management of the pandemic in Latin America have been fierce and have polarised political debate during a busy electoral calendar (Chile and Brazil). The temptation to increase fiscal spending ahead of the election in Brazil for example, is creating a conflict in policy mix and the central bank is preparing the market for more rate hikes as a result.

Inflation in EM was visible early in the cycle when compared to developed economies. Many started raising rates early in 2021 and are continuing to tighten monetary policy to preserve the hard-won credibility in inflation targeting. This is critical for current account deficit (CAD) countries that rely on foreign capital to finance their external imbalances.

Fig.2 - Emerging Economies' Consumer Price Inflation Rate (%, yoy)



Source: Macrobond as at 30th November 2021. For illustrative purposes only.

With the risk of inflation lasting and broadening, rate tightening is spreading across EM. Central European countries started late but are now accelerating the tightening. The tightening trend is now starting in Asia, with the exception of China. This has less to do with the trend in consumer prices than financial stability concerns, such as in South Korea.

The good news is that the largest CADs have improved by a couple of percentage points in GDP terms over the past two years.[3] For commodity exporters, the improvement in terms of trade contributed to the current account improvement, others benefited from the pandemic-induced weakness in domestic demand.

The other good news is that the rise in nominal GDP has largely limited the deterioration of the indebtedness ratio (government debt on GDP).[4] This helped to stabilise sovereign ratings despite wider fiscal deficits.

US rate tightening and the US dollar's trend are important for the external debt of EM countries. So far, the rise in the US dollar (the DXY index has risen by 8.4% since January 2021) [5] has been manageable, partly because it started from a very low base. Should the Fed be late in raising interest rates (or inflation be too high versus current projections), they will have no choice but to accelerate their policy rate adjustment. An early decision by the Fed to raise rates in 2022 would paradoxically be a better outcome for EM than if the Fed were behind the curve and running after the inflation numbers. The latter scenario would lead to a steeper US dollar and a rate rise too fast to be comfortably absorbed by EM.

China's economy slowed down in Q3 2021.[6] We expect to see a recovery as soon as within Q4, but the outlook for next year's growth is now slower than predicted a few months ago. A deceleration of the economy would not lead to heavy policy responses from the Chinese leadership.

Of course, the tolerance for too steep a deceleration is close to zero, but the management of the property developer crisis shows the strategic targets have shifted from high economic growth to financial stability and fairer income distribution.

We see the potential for global equity portfolios to reduce their secular overweight in Chinese equities, but we see this as a positive outcome for credit markets, with the government's rationalisation of credit policy forcing issuers to deleverage.

[3] National statistics and IMF World Economic Outlook data, October 2021
[4] National statistics and IMF Fiscal Monitor data, October 2021
[5] ICE US Dollar Index, Bloomberg, as at 30th November 2021
[6] National Bureau Statistics of China, 3Q2021 as at November 2021.

Global Real Rates to Rise in 2022

From an investment strategy standpoint, our base case scenario is that growth will remain elevated globally, with EM economies running faster in aggregate than DM economies but with a more positive momentum in the latter.

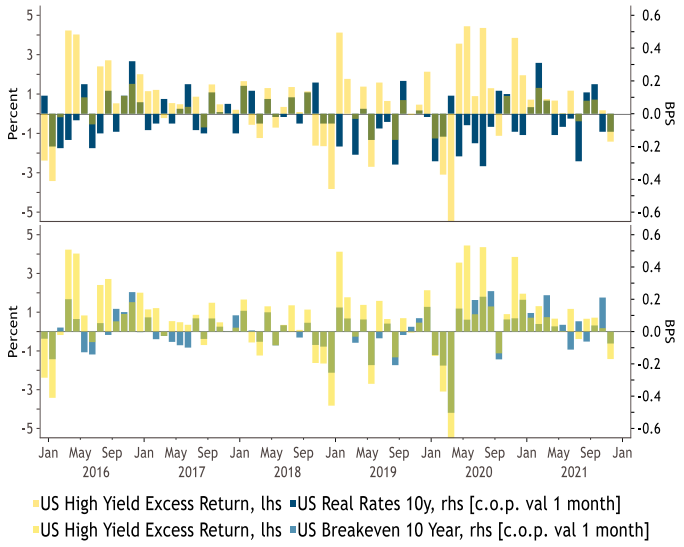
A continuation of above potential growth will help close output gaps and keep inflation distribution risk to the upside for next year, in our view. As a result, we expect real rates to rise from ludicrously negative levels.

A Year of Two Halves

Given the very negative base from which real rates would move up, we expect financial market participants to primarily focus on the gain from economic momentum. This means investors are likely to be overweight risk assets at the start of 2022, which is positive for equity and high yield credit, in line with the 2021 dynamic, provided lockdowns can be avoided.

Should supply chains be resolved and vaccination rates and treatment expanded globally, we could see a further unlocking of economic activity and therefore a move higher in rates. With short rate expectations no longer anchored at zero or negative levels, long yields would rise as real rates are repriced.

Fig.3 - Monthly Variation in Real Rates and Breakeven Rates (10yr) Compared with Monthly Excess Return in US High Yield



Source: Macrobond, ICE US High Yield Cash Pay Constrained (JUC0) Index, as at 30th November 2021, For illustrative purposes only.

A Move in Real Rates Matters for Credit Excess Return

When comparing the excess return of US high yield to components of nominal rates (breakeven inflation rates and real rates) over the past six years, a rise in real rates does not prevent the high yield market from providing excess return, but largely requires the addition of higher breakeven rates.

On the contrary, a fall in real rates increases the chances of positive excess return; the best combination being a fall in real rates with a rise in breakeven rates.

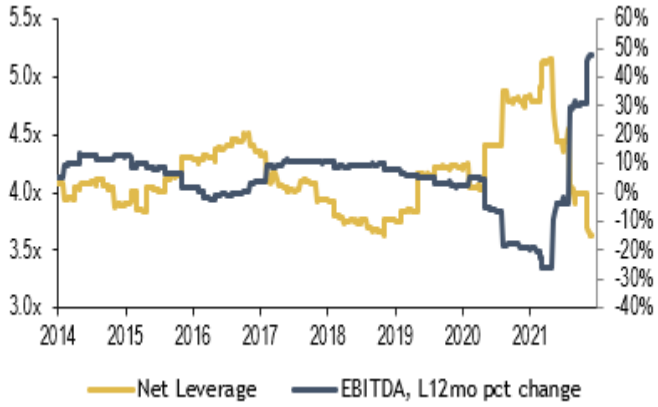
Fundamentals - Corporate credit fundamentals peaked in 2021 but remain positive

Corporate credit metrics have improved notably from the end of 2020 throughout 2021, amid a robust earnings cycle.

The combination of higher revenues and increased profitability has considerably improved corporate net leverage. Default rate have reached an historic low of 0.5% for US high yield in October 2021 and 0.62% for the European high yield market.[7]

The energy sector, the main contributor to defaults in 2020, has largely benefited from higher oil prices and defaults have declined to 1%.[8] Leveraged Loans have followed a similar pattern with a record low default rate in 2021 (0.7% for November 2021).[9] In parallel, recovery rates across sub-asset classes have significantly improved, a result of less severity when defaults occurred. [10]

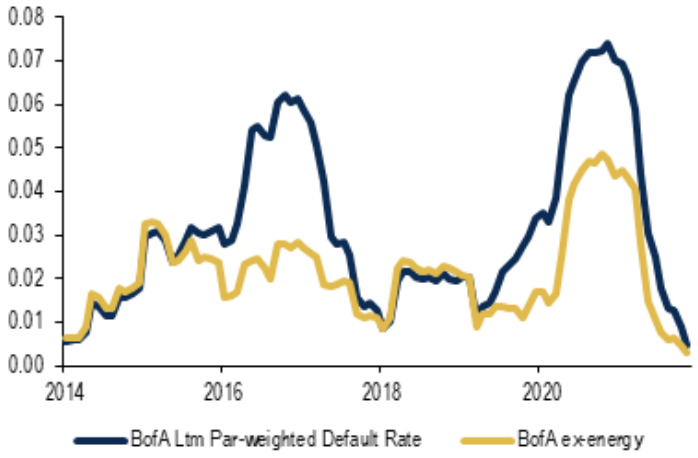
Fig.4 - US High Yield Net Leverage and EBITDA Growth



Source: BofA US High Yield Chartbook, 1st December 2021. For illustrative purposes only.

[7] BofA US High Yield Chartbook, December 2021
[8] BofA US High Yield Chartbook, December 2021
[9] Credit Suisse Credit Strategy Daily, 19th November 2021
[10] BofA US High Yield Chartbook, December 2021

Fig.5 - US Default Rate Par Weighted



Source: BofA US High Yield Chartbook, 1st December 2021. For illustrative purposes only.

We believe positive credit migration should remain a tail wind, especially for high yield, as the rating agencies continue to value balance sheet repair. As we recently highlighted (www.muzinich.com/opinions/us-high-yield-risk-on), the number of fallen angels has remained low this year while US$54bn of bonds have migrated from high yield to investment grade.[11] Estimates for further rising stars in the next 12 to 18 months range from US$80 - 200bn versus estimates for US$30bn of fallen angels for 2022.[12]

Whilst we are expecting economic growth to surprise on the upside in the next two quarters, we believe it is unlikely to further benefit corporate credit fundamentals, but could be a nice tailwind for further positive credit migration.

The risk of inflation denting earnings led our Asset Allocation Group to slightly downgrade our Fundamentals score at the end of the summer, although it remains in positive territory.

Higher inflation may act as a headwind on credit from now on, but also creates winners and losers depending on corporate pricing power and any remaining cost management efficiency left from the pandemic.

Yet there's no time for complacency. Corporates have increased liquidity through new issuance this year with cash sitting on balance sheets, thereby strengthening Fundamentals. But it's unlikely to stay there and the destination of this cash must be scrutinized.

It would be unsurprising to see a change of corporate behaviour towards more M&A, capex spending, financing and shareholder friendly share buy-backs as well.

However, the current Covid-induced uncertainty means this risk is hypothetical for now. The investment grade (IG) market may be more affected than high yield (HY), but HY is not immune to such a change in behaviour.

Technicals - Technicals expected to improve with lower net supply in 2022

After record issuance in 2020 in many credit markets, the trend continued in 2021 with an estimated c.US$1.5trn raised.[13] The forecast for 2022 is c.US$1.35trn with a rise in US financial issuance (40% of total gross) and a modest decline in non-financial issuance.[14] Net supply is expected to decline notably in 2022 by c. US$500bn, with more than US$600bn of maturities and high numbers of tenders and calls of around US$250bn.[15]

US high yield market issuance should see a decline in both gross and net terms. From an estimated US$500bn in 2021, new issuance is expected to fall somewhere between US$350 - 425bn.

In net terms, the fall could be even more dramatic when combining the rising star theme, some residual defaults and calls, leaving net issuance somewhere between US$5 - 50bn from close to US$190bn in 2021 (JP Morgan, 22 November 2021).

Fig.6 - Gross Issuance of US High Yield and Leveraged Loans

Source: JP Morgan 2022 High Yield and Leverage Loans Outlook, 22 November 2021. For illustrative purposes only.

[11] Goldman Sachs 2022 Global Credit Outlook, November 2021, 17 November 2021
[12] IBID
[13] IBID
[14] JP Morgan US High Grade Strategy & Credit Derivatives Research 15 November 2021
[15] Goldman Sachs 2022 Credit Strategy Outlook. US investment grade corporate market, 17th November 2021

In the leveraged loan market, the record gross issuance of 2021 (close to US$800bn) should remain strong in 2022.[16] We expect the demand for short duration floating rate instruments should continue and corporates will be keen to arbitrage new supply away from bonds to loans, depending on investor demand.

The increased demand for securitized credit instruments such as collateralised loan obligations (CLO) in a carry-hunting environment may also provide a robust demand floor for loan issuance. As a result, we could see a repeat of 2021 net issuance of close to US$400bn.[17]

We see three swing factors to these forecasts. One is that M&A activity could be significantly higher in 2022 and bond financing more significant compared to 2021. Such a pattern, if verified, would probably increase the net supply risk to the upside.

A second is the high revenue/high profitability pattern for corporates which, if maintained, would limit the use of bond issuance for capex spending and/or dividend pay-outs. The third is the rising star theme, which could see c.US$50 - 180bn of upgrades from high yield to investment grade, in addition to organic net supply for the latter (Goldman Sachs, November 2021).

In Europe the net supply outlook is more uncertain. This is partly because of the uncertain pace of the ECB's asset purchase programmes (at time of writing) but also because interest rates are more likely to stay lower for longer in Europe than in the US, potentially encouraging euro-based and non-euro based issuers to maintain opportunistic financing through euro-denominated issuance.

In addition, it is expected that the terms of the targeted long term refinancing operations will become less favourable, which could lead to more issuance of bank senior preferred bonds in the second part of the year. Given the positive background for the banks in general, such supply is not a source of concern.

On the other hand, the busy pipeline for M&A in Europe could change the new supply for 2022 from an absorbable programme to an indigestion risk. That explains why the 2022 new supply expectations for European IG range between €500 - 650bn with net issuance expectations at €100-300bn.[18] The rising star effect is obviously much smaller than in the US but would still amount to €17bn net.[19]

[16] JPMorgan 2022 High Yield and Leveraged Loans Outlook 22 November 2021
[17] JPMorgan 2022 High Yield and Leveraged Loans Outlook 22 November 2021
[18] JPMorgan European Credit Outlook & Strategy 2022
[19] JPMorgan European Credit Outlook & Strategy 2022
[20] JPMorgan European Credit Outlook & Strategy 2022
[21] IBID
[22] Goldman Sachs 2022 Global Credit Outlook, November 2021

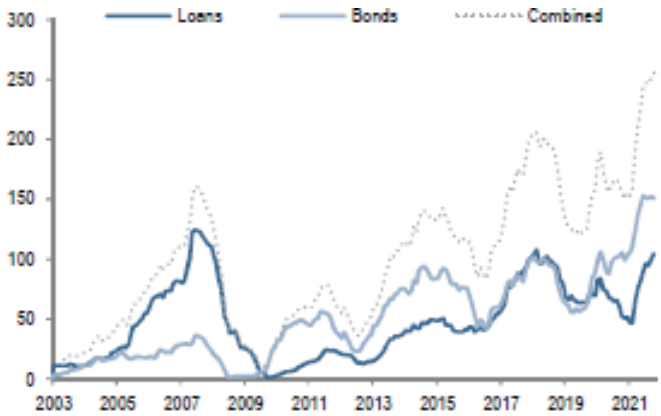
Fig.7 - Euro IG Non-Financial net Supply vs. M&A volumes, LTM €bn

Source: JP Morgan, Bloomberg LP. European credit Outlook & Strategy, November 2021. For illustrative purposes only.

The European high yield market went through its most active primary market in 2021, with €140bn of bonds issued and more than €100bn in loans (gross).[20] There are many reasons to believe high yield corporates can still be active in gross issuance in 2022. With reasonably good economic prospects for the eurozone in 2022 and a high level of "dry powder" in private equity, M&A financing and shareholder friendly operations could contribute meaningfully.

The level of refinancing and calls should also be high. With an average par weighted coupon of 3.5% and yields well below 3%, the incentive to refinance part of the old issues is there, and some estimates see close to €58bn of bond tendered or called in 2022.[21] European high yield gross issuance could approach €140bn, but with net issuance close to €70bn, 15% lower than in 2021.[22]

Fig.8 - 12 Month Rolling Euro HY and Institutional Loans Origination, €bn



Source: JP Morgan, S&P, LCD, European Credit Outlook & Strategy 2022, November 2021. For illustrative purposes only.

The European loan market is also expected to raise heavy cash in 2022 with estimates of €110bn gross and €40bn in net terms.[23] The institutional demand for low duration high carry instruments should also remain strong as well as the CLO warehouse, which we expect to grow further in 2022 with estimates of €30bn.[24]

ESG Issuance Growing

A remarkable structural change in the US and European credit new issuance programmes is the growing financing for ESG purposes through green, social and sustainable (GSS) bonds and new sustainability-linked bonds (SLB), both in IG and HY. In Europe between 20% and 25% of new issues have been ESG related.[25] In US IG, this represents only 6% of new issues but this has doubled in a year.[26]

We see this trend growing in 2022, particularly the use of sustainability-linked bonds whose proceeds can be used for general purposes, provided sustainability performance targets (SPT) are met.

Fig.9 - European High Yield GSS Issuance

Source: JP Morgan, Bloomberg. As at November 2021. For illustrative purposes only.

Fig.10 - European Investment Grade GSS Issuance

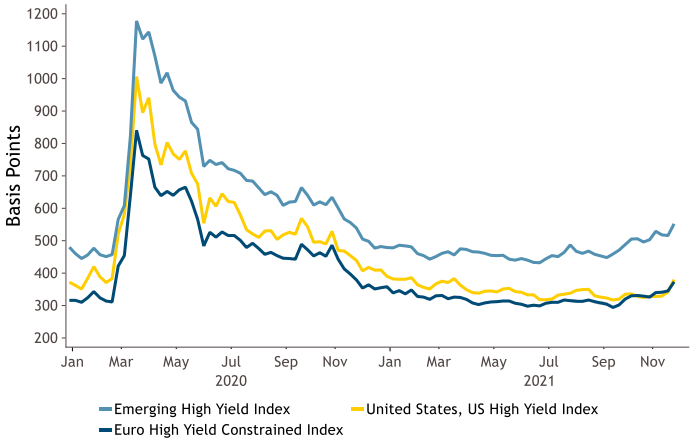
Source: Goldman Sachs 2022 Global Credit Outlook – November 2021. For illustrative purposes only.

Valuations - Could remain relatively tight for a prolonged period with more dispersion

Our Asset Allocation Group downgraded its Valuations scores as we exited the first half of this year. With the expected spread compression delivered, there was little incentive to keep our Valuations scores high.

However, we believe 'carry will continue to be king' in 2022. If DM yields increase, the benefit of carry is not put into question. Given that default risk is likely to be very low in 2022, we maintain our preference for higher-yielding assets.

Fig.11 - High Yield Market Spread to Worst



Source: ICE Index Platform, as of 3 December 2021. US High Yield Index (H0A0), European High Yield Index (HEC0), Emerging High Yield Liquid Index (EMHY). For illustrative purposes only.

Investors must nevertheless consider the volatility premium to reflect the macroeconomic environment and rates volatility, and the impact of faster-than-expected tapering by central banks.

We believe we could see more spread volatility in 2022. First, government bond markets are likely to continue to be highly volatile. Uncertainties around inflation and the consequential interest rate cycle are unlikely to abate.

Second, as we have already discussed, corporate issuance policies can go either way, even if our belief that this risk will be kept benign provided Covid-related economic uncertainty prevails. Third, dispersion reached very low levels in 2020 and is unlikely to stay that low given the above.[27]

[23] Goldman Sachs 2022 Global Credit Outlook, November 2021
[24] IBID
[25] IBID
[26] IBID
[27] Bank of America. US High Yield Chartbook, 1st December 2021. Dispersion is measured by the proportion of face value in the DM HY Index marked outside +/- 100 bps of overall index level

Fig.12 - Dispersion in US and European High Yield Market

Source: BofA US High Yield Chartbook, as at 30th November 2021. For illustrative purposes only.

Ongoing quantitative easing from most DM central banks while the global economy was recovering was a significant market driver supporting the buy-the-dip mentality through 2020-1H2021. However, there is now the prospect that these liquidity injections are likely to be quickly wound down, which highlights the greater tolerance of central banks to tighter financial conditions.

It is tempting to consider the spread widening we witnessed in November 2021 as compensation for increased volatility and the prospect of the end of liquidity injections by the Federal Reserve.[28] However, in the absence of deteriorating credit metrics in most corporate bond markets, we see little reason for shifting to a late-cycle type spread-widening pattern.

Our investment team's view remains constructive on the credit market for 2022, therefore assessing the right entry point into which credit segment is the main question.

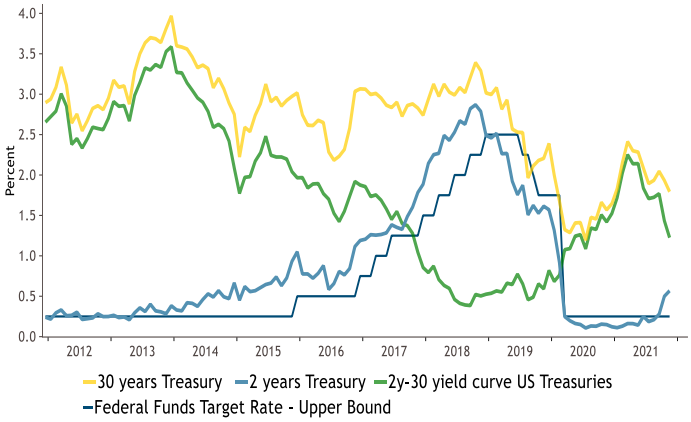
A More Tactical Approach to Duration

We have had a structural call for short interest rate duration strategies since the last quarter of 2020. The preference for credit came with little appetite for interest rate risk, often to take the most advantage from the credit opportunities.

In addition, one consequence of the tapering is for the central banks to stop absorbing some of the bond market's interest rate duration. As the inflation expectations were rising with the reopening of economies, there was little reason to reverse our preference for short duration exposure.

[28] Federal Reserve. FOMC meeting minutes, November 2021
[29] ICE Index Platform, ICE BofA Euro Corporate Index (C0A0), ICE BofA Euro High Yield Index (ER00), for several developed markets indices, investment grade and high yield, US High Yield Cash Pay Constrained (JUC0), US Corporate Master Index (C0A0), as at 30th November 2021

Fig.13 US Fed Funds Rate, US Treasuries 2y-30y, and spread 2y -10y



Source: Macrobond, Bloomberg as of 30th November 2021. For illustrative purposes only.

While we maintain our preference for credit risk over duration risk from a structural standpoint, there is room for a more tactical approach to duration in flexible portfolios. The market has been quick to translate the inflation surprise into steeper money market curves, but breakeven inflation rates have stopped from breaking levels expressing central bank tolerance for overshooting.

The flattening of the very long end of the curve, as short rates were jumping in October and November 2021, highlights the market's confidence in the long-term strategic framework of central banks. In addition, it is highly probable that yearly inflation measures will start to decline early in 2022, which should provide a more friendly environment for fixed income investors.

How to Express a Preference for Carry?

Spreads in DM markets have widened materially from their September tights, changing the overall value proposition.[29] When considering our z-score screening, DM investment grade markets have recovered some value, with European investment grade appearing the best value. In high yield, emerging markets appear attractive alongside European high yield.

Comparing high yield with investment grade, we consider the spread between the two asset classes continues to be attractive when adjusted from a duration standpoint.

The spread between US BBB and US BB for a 3y - 5y duration is 196bps, which is well above the 3-year average level from 2017 to 2019.[30] We believe this spread should widen by more than 70bps over 12 months to breakeven potential returns.

[30] ICE Index Platform, as at 30th November 2021. US BBB 3-5y Index (C2A4), US BB 3-5y Index (J2A1)

Within high yield, it depends on the risk tolerance of portfolios. Dedicated high yield portfolios could take advantage of what we expect to be a robust macroeconomic cycle to be overweight B rated bonds. This is where we have seen a lot of new issuance in 2021, in US dollar and euro markets.

This segment is moderately less exposed to convexity issues than BBs and offers around 150bps additional spread.[31] In our view, moving lower down the credit spectrum in CCC bonds is less attractive after the strong spread compression seen this year and expectations for higher dispersion in the asset class could mean decompression risks in lower rated credits.

Portfolios may seek to combine this B overweight with a high-quality bias to high rated BB bonds in a barbell-type risk allocation.

As discussed in the Fundamentals section, we expect rating agencies to continue to reward balance sheet repair and upgrade a number of issuers to investment grade. This rising star theme involves both US dollar and euro markets, but we believe may offer more opportunities in the former.

Meanwhile balanced crossover credit portfolios would also seek to take advantage of the positive rating migration by taking a large exposure to high yield, balanced with an overweight in BB rated bonds.

Exposure to hybrid corporates proved to be successful in 2021.* Our portfolios monetized the overweight to hybrid corporates when reducing their overall beta at the end of the third quarter.

Better valuations and signs of less supply would be needed for portfolios to return to an overweight position. If our views on the credit cycle are valid, hybrid corporate risk will remain low and valuations will be the main driver of investment decisions.

The short duration but long credit strategy which drove our overall positioning last year incorporated a significant exposure to loans where possible.

As high yield credit spreads were expected to narrow, and with a low duration due to their floating-rate structure, loans were a good fit with our views and outperformed bonds.[32] We see continued demand for loans from institutional investors.

*ICE Index Platform, from 31.12.20 – 30.09.21. Indices selected are for regional comparison purposes, determined by Muzinich as follows: The ICE Euro Non-Financial Subordinated Index (ENSU) outperformed the ICE Euro Senior Non-Financial Index (ENS0).

Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy.

Liability managers will likely use liquid high-grade assets to actively manage duration requirements, while locking in generous credit spreads with some loan exposure in a low default environment (Credit Suisse, 4th December 2021). In parallel, we believe the CLO high issuance programme could accentuate the demand for the asset class.

If we are correct in our prediction that fixed income volatility will remain elevated in 2022, both securitized credit and private debt investments should see high demand.

Both will help enhance the Sharpe ratio of portfolios but offer higher spreads for lower volatility than plain vanilla bonds. In a low default/sticky inflation environment, these instruments offer less duration exposure combined with some liquidity/complexity premia.

Currency Hedging Costs are Benefiting Euro-Denominated Credit

We believe major central banks may follow a different path to normalise monetary policy. The volatility of money market curves in these currencies (US dollar and euro) was particularly high in November, showing significant divergence in short-term forward rates, thereby changing the currency hedging pricing terms.

Some of the current pricing incorporates end-of-year balance sheet premiums (banks typically charge slightly higher costs for carrying forward rates operations on their balance sheets over year-end).

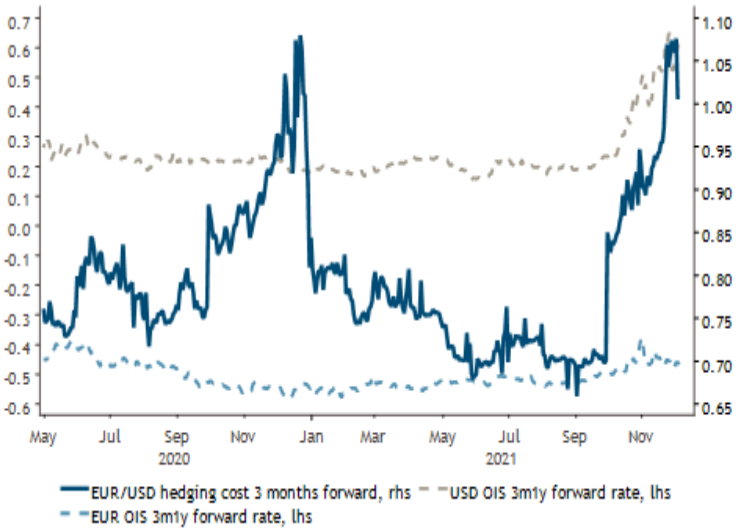
However, the magnitude of hedging cost changes has again become significant. Within a low yield/spread landscape, this premium can meaningfully impact relative value between assets.

Currently at a 1% annualised rate based on a 3-month forward contract,[33] this premium would be added to euro-denominated credit for a US dollar-based investor and retrenched from US credit yields for euro-based investors.

This FX hedging argument is reinforcing the view that euro-denominated credit, having materially underperformed US credit during the spread widening we have seen over the last three months, is now better value than US credit.

[31] ICE Index Platform, as at 30th November 2021. H0A1, H0A2
[32] CS Leverage Loans Indices (CSWELLI, CS ELLI) and US High Yield Cash Pay Constrained (JUC0)
[33] Bloomberg, as at 30th November 2021

Fig.14 - EUR and USD OIS Forward Rates and EUR/USD Hedging Costs on 3-Month Forward*



Source: Macrobond, Bloomberg, as 2nd December 2021. For illustrative purposes only. *OIS – Overnight Interest Swaps.

This is particularly true in high yield, in terms of yield and excess return. This might be a more balanced conclusion for investment grade where the divergence in short rates between US dollar and euros may have already priced in a lot of news related to potential Fed policy rates hikes in 2022.

Our Sector Allocation is Aligned With a Robust Macroeconomic Backdrop

We believe the period of large swing in sector rotations around the pandemic is over, as most of the opportunistic reopening themes have now largely matured. However, as the growth cycle is confirmed, the sector allocation became more structural around a few axes.

Our base case is that global growth running above potential in developed economies will at least keep demand for commodities high.

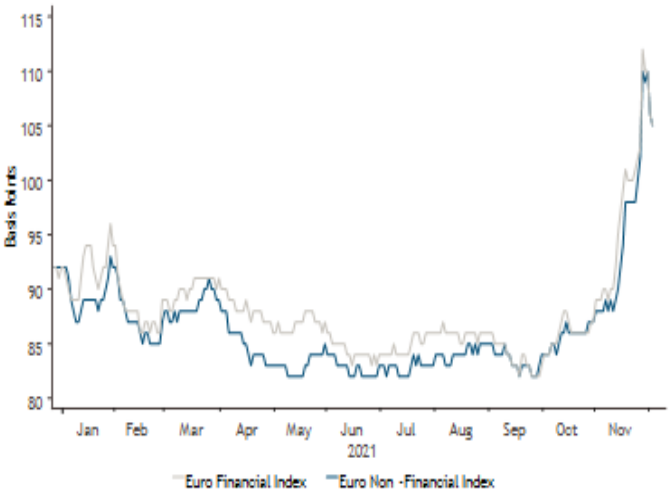
Commodity producers may also want to actively manage supply to keep prices elevated, which encourages us to have decent exposure to commodity producers across our portfolios, including emerging market ones.

Exposure to financials has been a recurrent theme in our portfolios in 2021 and continues to be our base case as we enter 2022. The allocation was mainly in European banks, emerging banks for EM portfolios, and diversified financials across all portfolios.

The normalisation in rates and steeper curves is usually a good environment for banks, where balance sheets appear healthy despite the severity of the recent recession.

The low default rate should be maintained next year. Diversified financials meanwhile should benefit from cash flow stability in the current economic cycle.

Fig.15 - Euro Non-Financials and Financials Spread to Worst



Source: ICE Index Platform, as of 2 December 2021. ICE BofA Euro Financial Index (EB00) and ICE BofA Euro Non-Financial Index (EN00). For illustrative purposes only.

While the easy picks in the reopening theme are gone, our US centric portfolios will favour sectors expected to benefit from pent up demand and the normalisation of operations in sectors such as cruise line operators, hotels, leisure parks and airlines.

The exposure to the automotive sector has been actively managed this year and is now a top five exposure in global and European credit portfolios.

Finally, as some of the above exposures have high beta features, our portfolios look for lower beta exposure through telecommunications, healthcare, broadcasting, media and some food retailers.

Conclusion

Provided the current progression of Covid-19 cases proves temporary, we believe global economic growth is likely to remain robust and provide a solid backdrop for corporate fundamentals.

However, we expect less synchronisation across regions as different domestic agendas and challenges will lead to differentiated policy responses. The global inflation shock could last longer than initially expected but will likely be addressed differently across the regions.

Credit spreads are historically tight in general, with the exception of Asia corporate credit.[34] Higher volatility and the end of central bank liquidity injections may increase the credit spread range for 2022 versus 2021. However, we believe we are not into a late-cycle moment and maintain our preference for high yielding assets over investment grade.

With strong credit metrics and net supply expected to decline meaningfully, we would add credit beta should spreads widen further. We maintain our philosophy for diversified portfolios as credit market dispersion is likely to return.

Higher hedging costs and relative value analysis currently favours European high yield over US high yield in relative terms. In investment grade, US investment grade may benefit from a stabilisation in the US dollar money market forward curve after November's substantial repricing.

Emerging market exposure offers new valuation opportunities but requires selective investment and smart stock selection. In this context, investors may want to take advantage of cheap Asian credit outside of the property sector.

We may need to be more tactical and active in our duration management in 2022. Uncertainties surrounding Covid-19, inflation and the reaction function of central banks, are factors that could generate high volatility. Overall, the odds are for a rise in real rates which favours credit risk to duration risk.

We remain confident in a short duration strategy over the medium term, but are cognizant of some opportunities in high quality, long duration assets to take advantage of inflows from long liability investors, combining with high yield credit short duration.

In periods of uncertainty, investors tend to prefer more liquid assets. However, in a low default, uncertain interest rate environment, private markets, with their higher yields and lower volatility could prove appealing.

Investors can assess this investment proposition through different solutions such as private debt, aviation and hybrid strategies that mix private and public market instruments, which may offer good value in this cycle.

[34] ICE Index Platform, as at 30th November 2021. ICE BofA Euro Corporate Index (C0A0), ICE BofA Euro High Yield Index (ER00), for several developed markets indices, investment grade and high yield, US High Yield Cash Pay Constrained (JUC0), US Corporate Master Index (C0A0), ICE BofA ML US High Yield Index (H0A0).

Index Descriptions

JUC0 - The ICE BofA ML US Cash Pay High Yield Constrained Index contains all securities in The ICE BofA ML US Cash Pay High Yield Index but caps issuer exposure at 2%.

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

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.

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.

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.

EB00 -The ICE BofA Euro Financial Index tracks the performance of EUR denominated investment grade debt publicly issued by financial institutions in the eurobond or Euro member domestic markets.

EN00 -The ICE BofA Euro Non-Financial Index tracks the performance of non-financial EUR denominated investment grade corporate debt publicly issued in the eurobond or Euro member domestic markets.

CS WELLI - CS Western European Leveraged Loan Index – The CS Western European Leveraged Loan Index is designed to mirror the investable universe of the Western European leveraged loan market. Loans denominated in US dollar or Western European Currencies are eligible for inclusion. The index is rebalanced monthly on the last business day of the month instead of daily. Qualifying loans must have minimum outstanding balance of $100 million (in local currency), issuers with assets located in or revenues derived from Western Europe, at least one year long tenor, be rated "5B" or lower, fully funded and priced by a third party vendor at month-end.

CS ELLI - CS Leveraged Loan Index – The CS Leveraged Loan Index is designed to mirror the investable universe of US dollar denominated leveraged loan market. The index is rebalanced monthly on the last business day of the month instead of daily. Qualifying loans must have a minimum outstanding balance of $100 million for all facilities except TL A facilities (TL A facilities need a minimum outstanding balance of $1 billion), issuers domiciled in developed countries, at least one year long tenor, be rated "5B" or lower, fully funded and priced by a third party vendor at month-end.

H0A1 - The ICE BofA ML BB US High Yield Index is a subset of the ICE BofA ML US High Yield Index (H0A0) including all securities rated BB1 through BB3, inclusive.

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.

EMHY - The ICE BofA High Yield US Emerging Markets Liquid Corporate Plus Index is a subset of The ICE BofA US Emerging Markets Liquid Corporate Plus Index including all securities rated BB1 or lower. The ICE BofA US Emerging Markets Liquid Corporate Plus Index tracks the performance of U.S. dollar denominated emerging markets non-sovereign debt publicly issued in the major domestic and eurobond markets.

ENSU - ICE BofA Euro Non-Financial Subordinated Index. ICE BofA Euro Non-Financial Subordinated Index is a subset of ICE BofA Euro Non-Financial Index including all subordinated securities.

ENS0 - ICE BofA Euro Senior Non-Financial Index ICE BofA Euro Senior Non-Financial Index is a subset of ICE BofA Euro Non-Financial Index including all senior securities.

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 account or fund.

Important Information

Muzinich and/or Muzinich & Co. referenced herein is defined as Muzinich & Co., Inc. and its affiliates. Muzinich views and opinions. This material has been produced for information purposes only and as such the views contained herein are not to be taken as investment advice. Opinions are as of date of publication and are subject to change without reference or notification to you. The Management Company may decide to revoke the arrangements made for marketing of its collective investment undertakings in accordance with the applicable laws at any time . Past performance is not a reliable indicator of current or future results and should not be the sole factor of consideration when selecting a product or strategy. 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. Rates of exchange may cause the value of investments to rise or fall. Emerging Markets may be more risky than more developed markets for a variety of reasons, including but not limited to, increased political, social and economic instability; heightened pricing volatility and reduced market liquidity.

Any research in this document has been obtained 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 judgment and this judgment may prove to be wrong. 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.

This discussion material contains forward-looking statements, which give current expectations of a fund's future activities and future performance. Any or all forward-looking statements in this material may turn out to be incorrect. They can be affected by inaccurate assumptions or by known or unknown risks and uncertainties. Although the assumptions underlying the forward-looking statements contained herein are believed to be reasonable, any of the assumptions could be inaccurate and, therefore, there can be no assurances that the forward-looking statements included in this discussion material will prove to be accurate. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation that the objectives and plans discussed herein will be achieved. Further, no person undertakes any obligation to revise such forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

US: This material is for Institutional Investor use only – not for retail distribution. Muzinich & Co., Inc. is a registered investment adviser with the Securities and Exchange Commission (SEC). Muzinich & Co., Inc.'s being a Registered Investment Adviser with the SEC in no way shall imply a certain level of skill or training or any authorization or approval by the SEC.

Issued in the European Union by Muzinich & Co. (Dublin) Limited, which is authorized and regulated by the Central Bank of Ireland. Registered in Ireland No. 625717. Registered address: 16 Fitzwilliam Street Upper, Dublin 2, D02Y221, Ireland. Issued in Switzerland by Muzinich & Co. (Switzerland) AG. Registered in Switzerland No. CHE-389.422.108. Registered address: Tödistrasse 5, 8002 Zurich, Switzerland. Issued in Singapore and Hong Kong by Muzinich & Co. (Singapore) Pte. Limited, which is licensed and regulated by the Monetary Authority of Singapore. Registered in Singapore No. 201624477K. Registered address: 6 Battery Road, #26-05, Singapore, 049909. Issued in all other jurisdictions (excluding the U.S.) by Muzinich & Co. Limited. which is authorized and regulated by the Financial Conduct Authority. Registered in England and Wales No. 3852444. Registered address: 8 Hanover Street, London W1S 1YQ, United Kingdom.