

April 2024

Asset Allocation View

Multi-Asset Credit

Muzinich & Co

Summary



Erick Muller
Director, Product & Investment Strategy



Michael McEachern
Co-Head Public Markets

Scoring - Fundamentals, Valuations, Technicals

	F	T	V	Avg.
Short Duration High Yield (J4CS)	0	1	1	0.66
US Loans (CSLL)	0	3	2	1.66
European Loans (CS Western Euro LL)	0	2	2	1.33
US IG (C0A4)	1	2	-1	0.33
US HY (J0A0)	0	1	-1	0.00
European IG (ER00)	1	1	1	0.33
European HY (HEC0)	0	2	-1	0.33
Emerging Market (EMCL)	2	2	-2	0.66

Red/Green: downgrade/upgrade vs. last month

Muzinich Z-score Analysis. Source: Muzinich & Co. Scale runs from -3 to +3 (-3 is the worst score, +3 is the best score). 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.

Key Positioning Takeaways

- With the global growth cycle expected to recover by year end, expectations for rate cuts, particularly in the US, have been delayed or reduced in magnitude. After a good month for the long end of the market in March, we reduced average duration positions in many global portfolios, mainly though US duration. The long end now looks expensive compared to the short or medium parts of bond curves. The risk of curve steepening has increased given unsettled fiscal trajectories in developed markets. A shorter average interest-rate duration position goes with an overweight to credit.
- Despite a large volume of new issuance in Q1, spreads remain tight and could stay that way or go even tighter in some segments. We believe attractive all-in yields will remain a dominant theme over the next few months, with a tailwind from lower net supply.
- We maintain our Euro credit overweight, although at more moderate levels than earlier this year. But the potential for spread compression looks more convincing in Euro credit than the US. EHY has underperformed US HY due to a few idiosyncratic events, but there is little evidence of contagion to the broader asset class with primary activity continuing.
- We maintain our appetite for financials, subordinated bonds and selected real estate exposure.

Market Themes - Watchlist



Fundamentals- Global macro cycle recovery and sustained profitability of corporate lead to a constructive momentum and some upward revisions in fundamental scores.



Technicals - Strong technicals with persistent inflows in the credit markets, absorbing large supply despite tight spreads. Scores are positive and with upgrades.



Valuations- Spreads remain expensive but inflows with large supply show investors’ tolerance for tight spreads. All-in yields remains attractive with limited risks on yields for now.



Tail Risks - Geopolitical tensions always severe but not evolving.

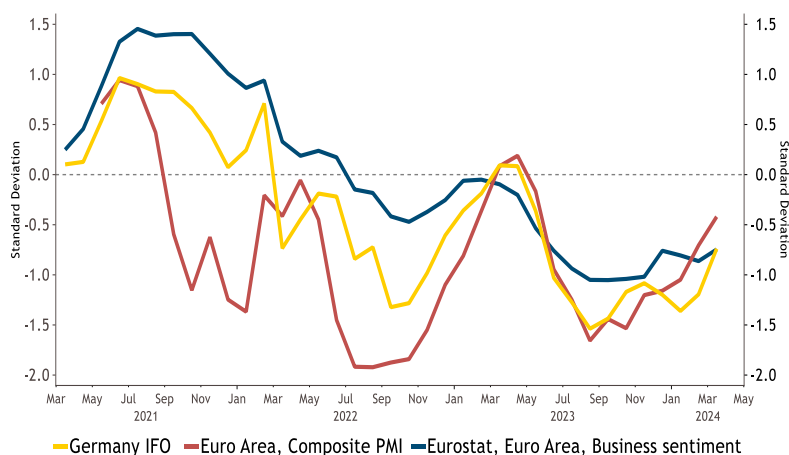
Indices used: J4CS - ICE BofA 0-3 Year Duration-To-Worst BB-B Cash Pay US High Yield Constrained Index. CSLL – Credit Suisse Leverage Loans Index. CSWELLI - Credit Suisse Western European Leveraged Loan Index. C0A4 -ICE BofA BBB US Corporate Index. J0A0 - ICE BofA US Cash Pay High Yield Index. ER00 - ICE BofA Euro Corporate Index. HEC0- ICE BofA Euro High Yield Constrained Index. EMCL - ICE BofA US Emerging Markets Liquid Corporate Plus Index. ADOL – ICE BoFA Asia Dollar Index. Please see Market Index Descriptions in the Appendix.

Top Down: Macro Credit View

Resilient growth supports risk assets

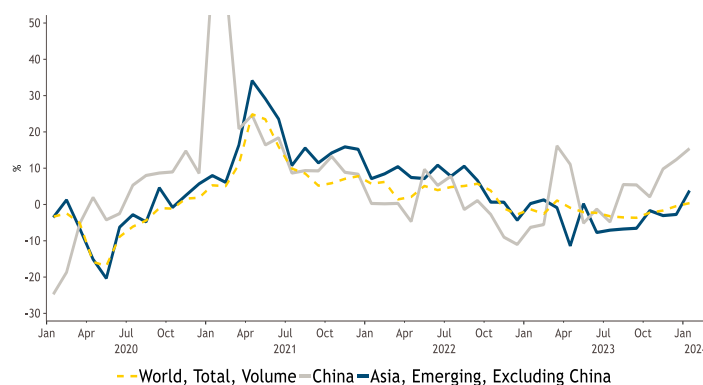
- Macro news flow was supportive of risk assets in Q1, led by upside surprises in the US economy, but also improving data from Europe. This has reinforced the narrative global growth is resilient to interest-rate tightening and its transmission through bank lending.
- Four factors have limited the pain from interest rates to growth: financial conditions eased materially in Q1; capital markets have been open to corporate refinancings, mitigating the effect of muted bank lending; job markets have been surprisingly strong, creating a solid base for demand; and fiscal policies have remained relaxed.
- Q2 is expected to confirm the positive sentiment around growth. We will pay particular attention to three factors:
 - European forecasts have reversed mainly on improving expectations of businesses, even though hard data have remained disappointing. IFO, EC March business surveys and Euro PMIs have all seen a rebound based on positive business outlooks. Meanwhile, German retail sales in Jan/Feb were 7% lower than the Q4 2023 base.

Fig 1. Euro business indicators (normalised)



- China PMI surveys surprised on the upside in March. The manufacturing index rose above 50 for the first time in 7 months, while the service index jumped to 52.4. More importantly, the construction PMI rebounded to a comfortable 56.2. However, we need to see confirmation of the rebound well beyond the Chinese New Year period.
- The improving China dynamic should benefit other Asian countries. A way to measure will be to see if the recent rise in exports across Asian countries continues.

Fig 2. Global, China and Asia ex-China exports (year-on year, %)



Mind the Euro sovereign spread gap

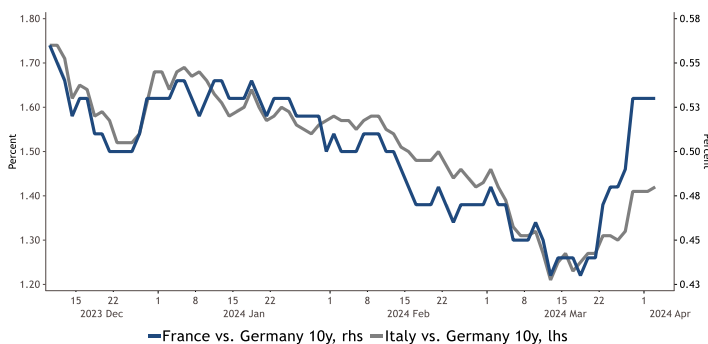
- The 10-year Bund yield has been directionless since early February, oscillating in a 15bps range. However, intra Euro government bond spreads widened in late March/early April. Neither growth nor inflation data justify such a repricing of risk premia. 2024 budget plans were all based on inflated economic growth numbers, as were last year's budgets. The downward revision of growth assumptions led to a significant overshoot of 2023 deficits and changes to 2024 budgets. For instance, the 2023 French deficit was revised to 5.5% of GDP from 4.9%. The 3% deficit objective has been pushed back to 2027 and sizable spending cuts are needed to maintain the credibility of the 2024 budget as well as France's credit rating.
- France is not an isolated case. Other countries, including Germany, have been forced to revise down their economic projections. A few months before the European elections in June, no government is speaking about higher tax rates. However, this fiscal challenge will have to be addressed with many countries at risk of facing Excessive Deficit Procedures as part of the EU's fiscal framework. The European Commission announced on April 3, 2024, it will open a deficit infringement procedure against Italy. This is not inconsequential: not being subject to EDP procedures is a prerequisite for countries to benefit from the potential activation of the Transmission Protection Instrument by the ECB in cases of severe spread widening. It is notable recent spread moves in Euro government bond happened when expectations were heightened that the ECB will cut rates in June.

Top-Down Macro Credit View

We see no other explanation than a fiscal policy premium for this spreads move. It could stop there if the economic rebound markets anticipate from business surveys is confirmed.

However, we would not exclude the need for more stringent fiscal policy announcements after the European elections, which would cap the demand recovery in the second half of the year. Not proceeding with spending cuts will prevent long yields from following short rate cuts.

Fig 1. EGB spreads have widened on fiscal concerns



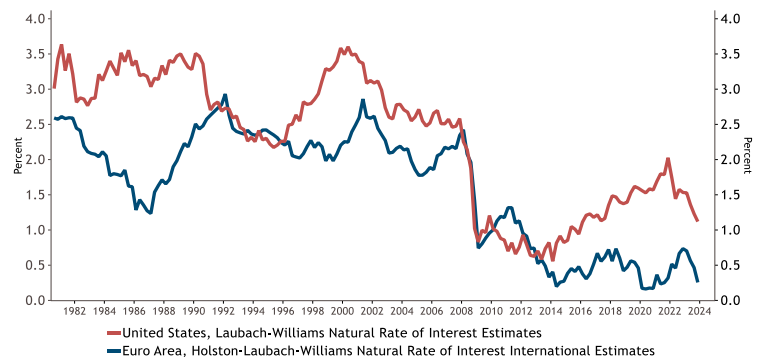
What happens after June?

- Although the latest inflation data released in the US and Europe have not been unsettling, the Fed and ECB maintain their “forward guidance” for rate cuts. ECB president Lagarde has been slightly more explicit for June, while Fed chair Powell has been less overt. Maybe the most important question is what happens after June-September. Speed, magnitude, the sequence of cuts and where terminal rates settle are essential questions for duration positioning.
- We keep the view that the ECB could cut rates before the Fed or the BoE, with limited consequences on yield curves or foreign exchange, provided the Fed maintains the guidance it will follow shortly after. Keeping the path of rate cuts synchronised beyond June-September appears more challenging for a few reasons:
 - a. While US growth seems to run at or slightly above potential, this is not the case for the Eurozone, which is running a good percentage point below potential growth. The need to adjust the restrictive stance seems more urgent in Europe than the US, which is seen in the Fed narrative it is in no hurry to cut.
 - b. Another lively debate is whether terminal rates will be modified on the upside soon, integrating an upward revision to natural interest rates (r^*).

Estimating r^* is a function of many variables, such as total factor productivity and ISLM model estimates, but also structural changes including integrating AI into production process, supply chain reshoring, and the investment needed to mitigate the effects of climate change.

The consensus seems to be that r^* estimates have risen. Isabel Schnabel suggested “structural challenges may have a persistent positive impact on the natural rate of interest” (read here). However, she fell short of qualifying the influence of r^* estimates for monetary policy decisions in the short term.

Fig 2. Estimates of US and Euro natural interest rates (LW and HLW models): towards an upward revision?



- c. The US elections may also be a factor, depending on market perceptions of how the outcome could impact public investment or private sector demand.
 - d. Finally, if there are similar patterns in the resilience of the labour market in facing volatile macro conditions, we could see some divergence with Euro employment softening in 2024 amid an economic stagnation scenario and wage settlements remaining high.
- There are many reasons why the direction of short rates may diverge between the Eurozone and US after the rate cut sequence is initiated. But a large or lasting divergence would increase the risk of market volatility, including in FX.
 - Our current forecasts are based on a terminal rate of 3.25% in the US and 2.25% in the Euro area by 2H25 but with risk tilted on the upside. Our duration exposure, which was neutral to slightly overweight depending on the portfolio, has been shortened for next month.
 - The risk of a further delay to US rate cuts could cause long yields to increase, even if short rates are stable in a bear steepening adjustment. Being more exposed to European rates than US rates for the next couple of months makes sense within this global duration underweight.

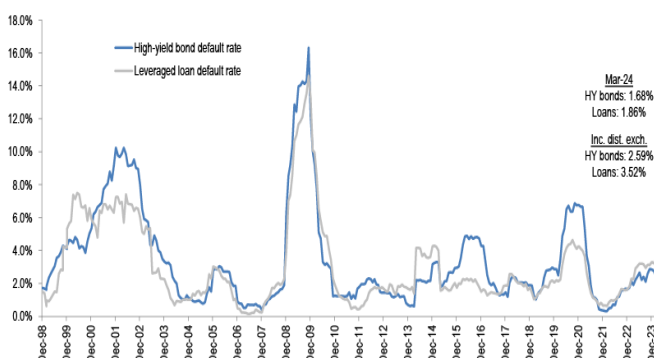
	US		Europe		EM
	IG	HY	IG	HY	IG
Fund.	1	0	1	0	2

Red/Green: downgrade/upgrade vs. last month

A constructive flavour to Fundamentals

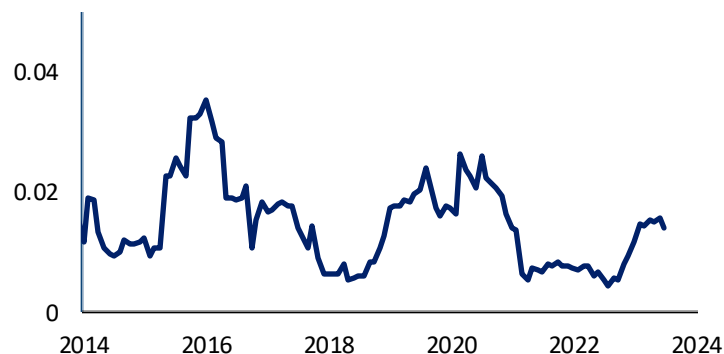
- From a macro perspective, the upward revision in US economic momentum is a net positive for US corporate fundamentals. With the likes of the International Monetary Fund updating in January their forecasts for US GDP above 2% and US non-financial profits rising by 9% (SA, AR) in Q4, this is a strong environment for US companies.
- We still prefer large to small caps from a credit metrics perspective but expect the default rate to stabilise by mid-year and fall back by year-end. We note a large positive ratings drift in US IG over Q1.
- Default activity was moderate in March, in contrast to February. According to JPMorgan¹, defaults totalled less than US\$2.5 billion in Q1 for bonds and US\$7.2 billion for loans. Including distressed exchanges, the default rate increased to 2.26% for bonds and 3.5% for loans.
- The default rate stabilised in European high yield in Q1, according to Fitch Ratings, with no defaults in March. Our fundamental scores remain unchanged.
- There were a few idiosyncratic events in March for EHY. Three issuers saw bond prices fall materially and experienced rating downgrades. The fact their balance sheets were over levered was well known, but the actions taken by these issuers to address the unsustainability of their capital structures, sometimes with radical shifts in the treatment of bondholders, was a clear negative.
- However, the risk of contagion to the broader market, including to weaker credits, has not materialised. We maintain our view that fundamentals are solid enough in general, with a moderate rise in defaults but no obvious systemic risk.

Fig 1. US default rate rises, but moderately



- With the market expecting fewer Fed rate cuts than earlier in the year, interest coverage ratios return as a key metric for investors. With an average ratio close to 5x at the end of 2023 in US HY, there is a comfortable margin to absorb higher rates for a while, even if the ratio is expected to decline further in 2024.
- There is, however, dispersion across sectors with technology, media and communications appearing more vulnerable.

Fig 2. Europe high yield default rate stabilises in 2024



- The ratings drift may deteriorate further in EHY due to the above events. We are also seeing similar deterioration in US HY due to defaults and downgrades of some CCC-rated companies, but the drift in BB and B-rated companies remains marginal.
- Emerging-market debt kept its strong score, given strong balance sheets and earnings. The ratings drift is positive in EM with more upgrades than downgrades. Further loosening in monetary policies generally is supportive of the positive fundamental score.

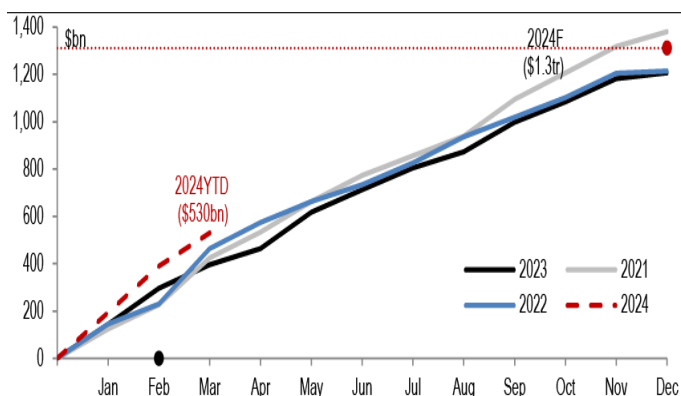
	US		Europe		EM
	IG	HY	IG	HY	IG
Tech.	2	1	1	2	2

Red/Green: downgrade/upgrade vs. last month

Technicals strong and improving

- With gross issuance of US\$141 billion, according to S&P figures (as of March 31, 2024), March was a busy month for US IG, but there was no difficulty in absorbing this supply.
- Q1 saw US\$530 billion printed (US\$380 billion in net terms), with US\$323 billion of non-financial issuance, as of March 31, 2024, making it the strongest first quarter for primary activity in the past four years. Issuers are taking advantage of low spreads and affordable all-in yields to refinance and take on new debt.
- According to JPMorgan in its March review of bond market activity, Q1 issuance in US IG could represent 40% of the total for the year. It is possible the US elections will reduce the market's capacity to absorb supply, so issuers are front loading planned refinancings instead of waiting for lower rates.
- Long-dated issuance rebounded in March, meeting strong demand. Issuers have taken advantage of the expected rebalancing of diversified portfolios from equities to bonds after the exceptional performance of US equities in Q1.

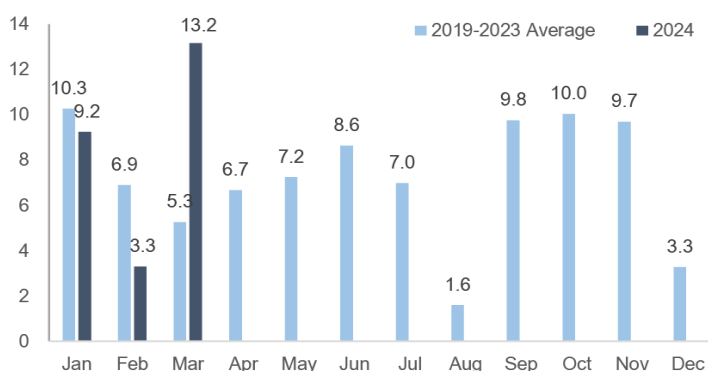
Fig 1. US IG in Q1 40% of 2024 estimates



- US\$28 billion of HY bonds were issued in March (US\$8 billion in net terms), according to trade association SIFMA (as of March 31, 2024), with issuers refinancing short-dated bonds for longer maturities. Investor demand absorbed all the issuance with little concessions.

- Over Q1, close to US\$88 billion was issued, around twice what was printed in the same period in 2022 and 2023, according to SIFMA (as of March 31, 2024).
- Strong secondary market performance shows the robustness of investor demand. A large share of new issues are secured bonds, which shows issuers' intent to refinance bonds while locking in the lowest possible spreads.

Fig 2. European high yield primary activity



- The Euro IG market issued €58 billion in March and €203 billion in Q1 (€98 billion in net terms), according to JP Morgan as of March 31, 2024, including €107 billion from non-financials (€46 billion in net terms).
- The average duration of new issuance increased by a year to 7.5 years in Q1, with strong demand for long-dated paper (as of March 31, 2024).
- March was active in EHY with €14 billion printed, the highest level since 2021 (as of March 31, 2024). Despite the difficulties facing a handful of EHY names, this did not stop other issuers from refinancing. All segments were active, including subordinated financials and AT1 bonds, and issuance was absorbed with little to no concession and secondary spreads tightening over the period.
- The outlook remains strong, with persistent inflows despite tight valuations and, in EHY, no contagion from severe, but isolated, volatility facing specific issuers.

Sources: Fig. 1 : JPMorgan US High Grade Corporate Bond Issuance Review, as of March 2024. Fig. 2: JPMorgan, Final Score EHY Q1 review, as of March 2024. Muznich views, opinions are for illustrative purposes only, not to be construed as investment advice or an invitation to engage in any investment activity, subject to change. See Important information at the end of this presentation regarding forward-looking statements.

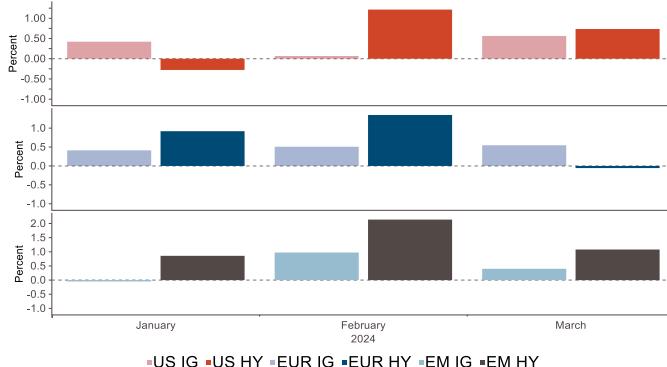
	US		Europe		EM
	IG	HY	IG	HY	IG/HY
Val.	-1	-1	1	-1	-2

Red/Green: downgrade/upgrade vs. last month

Spread valuations expensive but lack of negative catalyst leaves value in yields

- At the index level, March saw solid performance in total and excess returns. This started with positive total returns in government bonds, with the long end outperforming, Europe outperforming US bonds and peripheral outperforming core Euro bonds, despite spread widening at the end of the month.
- Within credit, US IG matched US HY total returns but EHY underperformed vs. Euro IG. In excess return terms, US HY and EM HY outperformed with EHY again suffering from idiosyncratic events with severe price falls for certain issuers. EHY has seen a large rise in dispersion due to these events.
- The long end of credit markets outperformed in total return terms, contrasting with January and February. In total return terms over Q1, the US IG index was hurt by a longer duration within a rising yield environment but performed well in excess return terms.

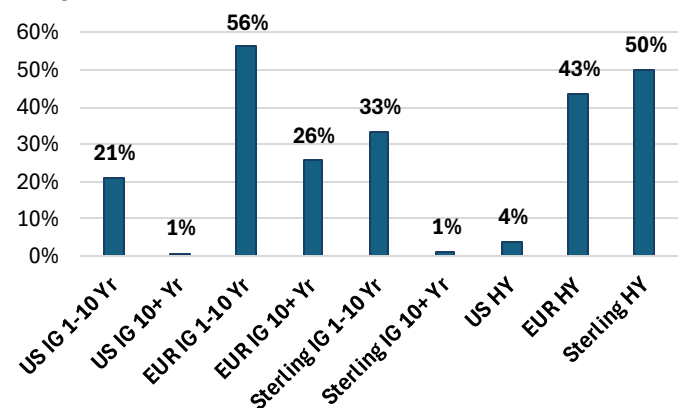
Fig 1. EHY excess return hurt by idiosyncratic events



- Despite tighter spreads, our investment team remains constructive and does not see the current levels as a hard floor. Technical factors remain favourable, indicating a degree of investor tolerance for expensive markets, as we have seen in equity markets. Volatility remains low as measured by the VIX.

- Unless a new spike is seen, we believe spreads should stay compressed. They could even go tighter if the macro scenario remains supportive. Postponing the Fed first rate cut has not altered the appetite for risk assets, leaving expectations of tighter spreads intact.
- Fig 2 below shows how much time spreads in certain credit markets have been tighter than those at the end of March. While some market segments are close to their historic floors (most of them being long-duration segments or US HY), others have seen lower spreads for long periods. This reinforces our call for preferring Euro credit exposure over the US in terms of regional diversification.

Fig 2. % of time spreads tighter than now in past 10 years



- Finally, our conversations with clients reinforces our conviction that the carry argument, i.e. the yield available this year alongside limited tail risks on the direction of rates, is the most powerful explanation for spread tightening. This suggests a limited change higher in government bond yields for the remainder of the year would not upset credit investors in their yield "search and capture" campaign.
- In general, valuation scores were left unchanged except for EM, where the spectacular tightening seen YTD, which was probably underestimated by many investors, makes the relative value play versus US\$ domestic bonds expensive.

Past performance is not a reliable indicator of current or future results.

Source Fig. 1: Macrobond, Bloomberg as of March 31, 2024. Excess Returns per market and rating segments. ICE BofA Index US Corporate Index (C0A0), US High Yield Index (H0A0), Euro Corporate Index (ER00), Euro High Yield (HEC0), Emerging Corporate Liquid Plus Index (EMIB), Emerging High Yield (EMHB). For illustrative purposes only. Fig. 2 : Source: Muzinich calculations using data from ICE Index Platform. Data as of February 29th, 2024. EUR IG: ICE BofA Euro Corporate Index (ER00). US IG: ICE BofA US Corporate Index (C0A0). GBP IG: ICE BofA Sterling Corporate Index (UR00). EM IG: ICE BofA Emerging Markets Liquid Corporate Plus Index (EMCL). EUR HY: ICE BofA Euro High Yield Index (HE00). US HY: ICE BofA US Cash Pay High Yield Index. GBP HY: ICE BofA Sterling High Yield Index (HL00). Indices selected as best available proxies for the respective markets. For illustrative purposes only.

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