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.

Value in Credit?
March 14, 2022

At the end of last year, we wrote that markets were in a speculative phase (please click here). With the tragedy unfolding in Ukraine and persistent concerns about inflation, fear has now started to replace greed in markets, which may create interesting opportunities for long term investors. It is very difficult to time markets, but we believe a focus on fundamentals during periods of volatility helps provide a framework for good decision making.

Yields

Global credit markets have repriced significantly this year. In the US, the yield investors earn for lending to high yield companies has moved from 4.2% at the start of the year to about 6.1% today. In Europe, yields have moved from 2.9% to approximately 4.6% in Euros.

While earlier in the year most of the increase in yields was due to rising interest rates, spreads have now also significantly widened. In the US spreads are currently 415 vs 322bps at the start of the year. In Europe, the spreads are 462 bps compared to 341bps at the start of the year. Spreads in Europe are now wide of their 10-year average (414bps), while spreads in the US are currently inside the 10-year average (463bps).

Spread levels allow a calculation for how high default rates have to be for investors to lose money. Currently European and US spreads imply cumulated default par value rates of 31% and 28%, respectively, over the next five years, assuming a 40% recovery rate. These five-year levels of cumulated defaults have not been seen over the last 15 years, even during the Great Financial Crisis; so, we believe investors are now beginning to have a margin of safety.

To further put this in perspective, as of March 2022, JP Morgan was expecting US default rates to be less than 0.75% and European default rates to be less than 2% for the next 12 months because of strong fundamentals. Will the situation in Ukraine effect default rates? US and European high yield markets have little direct exposure to Russia/Ukraine from a revenue perspective - in the US, virtually no companies in the high yield universe have meaningful exposure to Russia/Ukraine, and in Europe, corporates directly exposed to Russia/Ukraine are less than 1% of the universe; so, any effect on defaults would be indirect, such as from exposure to higher energy or commodity prices. It is difficult to imagine that such indirect exposure to Russia/Ukraine will cause defaults to spike to levels above the break-even calculation.

Fig. 1 - Yields Have Increased to Levels Implying Higher Future Default Rates*

<table>
<thead>
<tr>
<th></th>
<th>Spread</th>
<th>10-year average</th>
<th>Cumulative breakeven default rate over the next 5 years (40% recovery)</th>
<th>Expected default rate (JP Morgan**) for next 12 months</th>
</tr>
</thead>
<tbody>
<tr>
<td>US High Yield</td>
<td>415</td>
<td>463</td>
<td>28%</td>
<td>&lt;1%</td>
</tr>
<tr>
<td>Eur High Yield</td>
<td>462</td>
<td>414</td>
<td>31%</td>
<td>&lt;2%</td>
</tr>
</tbody>
</table>

Source: *ICE Index Platform, as of March 11, 2022. US High Yield: J0A0 and European High Yield: HEO. **JP Morgan Default Monitor, as of March 1, 2022 and JP Morgan High Yield Talking Points, as of March 3, 2022. For illustrative purposes only.
Fundamentals

Generally, companies on both continents entered the year with strong balance sheets and sound liquidity profiles. Coming out of the 2020 Covid liquidity scare, companies pushed out maturities, so the need to refinance over the next couple of years is generally low.

This is important because an inability to refinance is a key driver of defaults. In the US, only 4% of high-yield bonds need to be refinanced in the next two years. In addition, the quality of companies in the HY market have generally improved over the last few years, as illustrated in Fig. 2. In the US, 53% of the market is rated BB and 10% CCC. In Europe, 73% of the market is rated BB and 5% CCC.

Fig. 2 - High Yield Ratings Migration is the Strongest in Twenty Years.

We do not try to predict how markets will evolve in the very short term, and geopolitics could certainly cause more volatility. But over time, the return for investors in corporate credit is driven by whether the coupon being earned outweighs the cost of defaults. As seen in Figure 3, when spreads have historically reached current levels, the vast majority of forward 3-year returns have been positive.

Aligned with this, we note that since the inception of Muzinich’s US high yield strategy composite in January 1991, Muzinich has delivered positive net results in 99.7% of the rolling five-year periods, measured monthly, regardless of spread conditions when the investment was made. Similarly, since June 1, 2000, our European high yield strategy has delivered positive net results 99.0% of the time. We believe bond math is starting to work in investors’ favour, creating opportunity for those that have a longer-term investment horizon.
**Fig. 3 - Historically, Long-Term High Yield Investors Have Been Rewarded at Current Spread Levels**

The figures shown relate to past performance. 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.

*Source: Muzinich analysis. Data as of March 11, 2022. For illustrative purposes only. Date range of data is September 30, 1988, to March 11, 2022. Returns are the cumulative 3-year returns for the ICE BofA ML US HY Cash Pay Index (J0A0). Spread-to-Worst of J0A0 index. Gray dots represent the period 7/31/2005 - 6/30/2006, leading up to the Great Financial Crisis. Strategies can lose money and will be impacted by market conditions*

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1. ICE Index Platform ICE BofA ML US Cash Pay High Yield “J0A0” Index, March 11, 2022
2. ICE Index Platform ICE BofA ML Euro High Yield Constrained “HECO” Index, March 11, 2022
Index Descriptions

JOA0 - The ICE BofA ML US Cash Pay High Yield Index tracks the performance of US dollar denominated below investment grade corporate debt.

JOA1 - The ICE BofA ML BB US Cash Pay High Yield Index is a subset of the ICE BofA ML US Cash Pay High Yield Index (JOA0) including all securities rated BB1 through BB3, inclusive.

JOA3 - The ICE BofA ML CCC & Lower US Cash Pay High Yield Index is a subset of the ICE BofA ML US Cash Pay High Yield Index (JOA0) including all securities rated CCC1 or lower.

HECO - The ICE BofA ML Euro High Yield Constrained Index contains all securities in the ICE BofA ML Euro High Yield Index (HE00) which tracks the performance of EUR denominated below investment grade corporate debt publicly issued in the euro domestic or Eurobond market, but caps issuer exposure at 3%.

Risk: Index performance mentioned in this material is for illustrative purposes only. You cannot invest directly in the index.

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