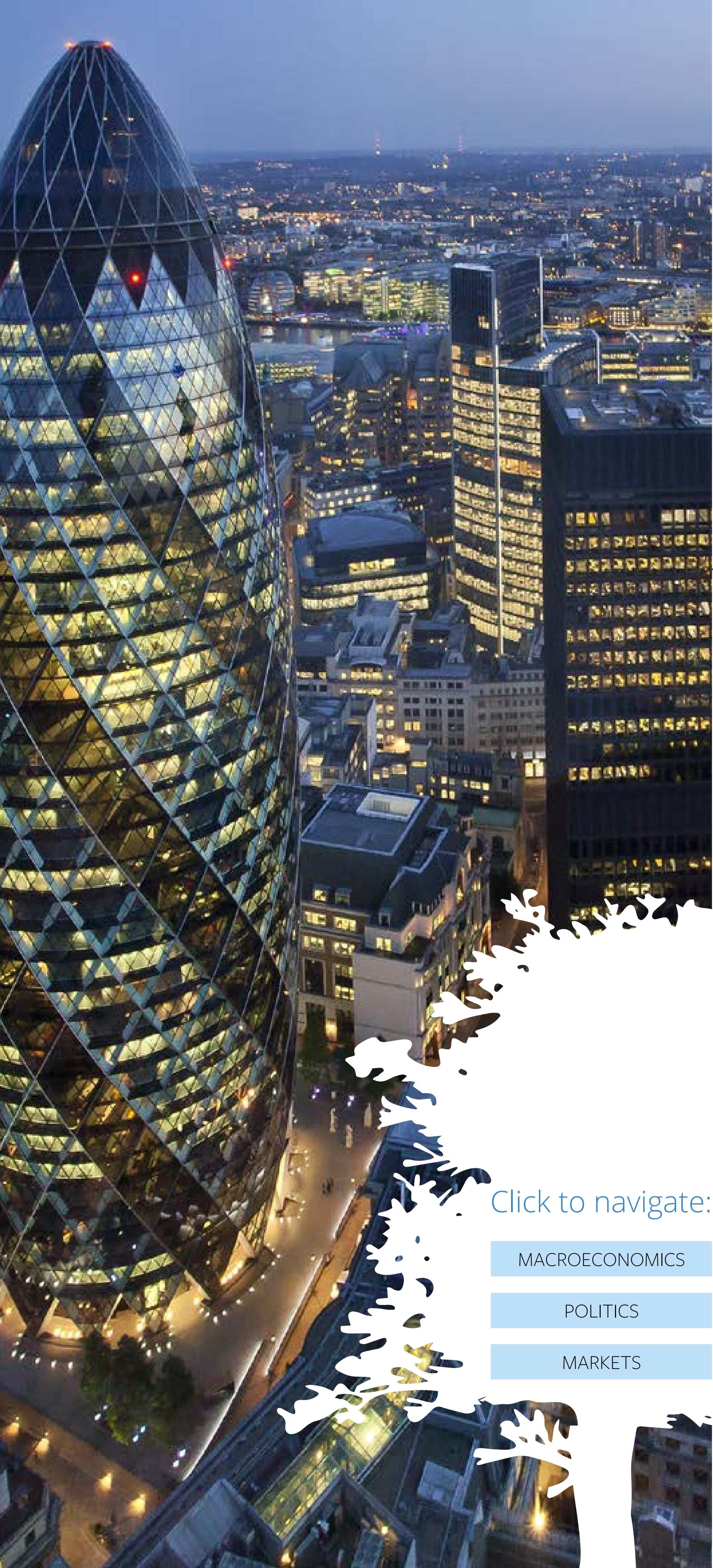
PEMBERTON
Connecting Capital Across Europe



An even keel through choppy waters

PEMBERTON MACRO VIEW
Q2 2019

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The European macro outlook continues to be supportive for private debt. Moderate growth forecasts for the EU of 1.1% for 2019 and low interest rates provide a benign credit environment. Accommodative monetary policy across major economies has buoyed stock markets, despite concerns over global political tensions. Within leveraged lending, private debt continues to provide compelling relative value versus the broadly syndicated market.

Eurozone Economy[1]

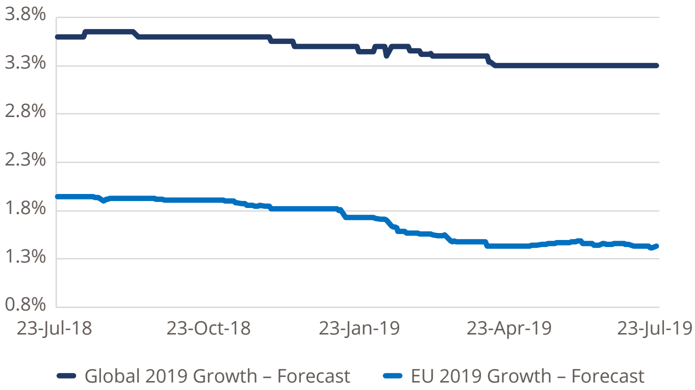
The current ECB forecast for 2019 Eurozone GDP growth is 1.1%. This reflects the 1.6% drop in Eurozone industrial production in June and the steeper reduction in Germany (with its exposure to exports and autos). We maintain our view that a low growth environment supported by monetary stimulus remains benign for credit.

Global Growth

Market consensus is now aligned at 3.3% for global growth in 2019. Whilst Chinese growth is slightly lower, it still remains at 6.2% and is showing signs of domestic support offsetting the impact of tariffs from the US. It should be noted that revisions to EU-wide growth forecasts have moved almost in lockstep with global equivalents (see right). We continue to believe that global growth above 3.0% is supportive for European credit. This is especially true in light of ongoing trade wars, which are constraining output measures.

1. Source: TheGuardian.com, Jul-19

2019 Growth Forecasts –Bottoming Out



Source: Bloomberg

UK Economy

The UK economy shrank for the first time since 2012 in the second quarter by 0.2%. This is on the back of PMI indices showing that services barely grew in June whilst both construction and manufacturing saw contractions. Accordingly, the median forecast for the base rate as of 1Q20 dropped to 75bps from 1.25% back in January, with some even calling for a rate cut in 2020.
We remain disciplined around our UK exposure as part of a balanced pan-European portfolio. We view BoE measures (e.g. 100-day liquidity provisions vs the usual 30) as constructive in case of Brexit volatility.

European Interest Rates[2]

The ECB's tone became increasingly dovish through 2Q2019, with many predicting a rate cut of 10bps following the September meeting. This is on the back of Eurozone inflation data for July that came in at 1.0%. This inflation level was higher than expected but remained well below the central bank's target rate of just below 2%. We consider a sustained low-rate environment with moderate growth as relatively benign for European credit.

GBP Interest Rates & FX

The Bank of England's official position remains that interest rates could move in either direction in the event of a disruptive no-deal Brexit scenario, because it would need to assess which was the greater threat: recession or rising inflation.[3] However, recent comments by Gertjan Vlieghe, a member of the rate-setting MPC, that he would be prepared to cut borrowing costs aggressively in the event of a no-deal Brexit, suggest a stimulating rate cut would be a key part of UK policy. Meanwhile GBP has weakened ~4% through the quarter, in sympathy with increasing likelihood of a no-deal Brexit. We view massive Bank of England and Treasury support as likely in the event of a hard Brexit.

US Interest Rates[4]

Following the 4Q18 change to a more dovish commentary, the Fed cut interest rates by 25 basis points at its July meeting. Globally, more than a third of central banks have now eased rates in the last 6 months. Dovish US rate policy seems likely to support US and global economies and reduce the likelihood of a sharp shock impacting global credit in the face of trade tensions, weakening global growth and persistent low inflation.

Cross-Currency Uplift[5]

Despite US rates falling from November highs (10yr down from 3.2% to 2.1% as of writing), the pickup vs EUR rates remains 3.0% for US based investors in European Direct Lending (see below).

Illustrative direct lending return adjusted for local currencies

	EURUSD	EURGBP	EURAUD	EURJPY	EURCAD
6m FX Forward Implied Differential	**2.98%**	**1.34%**	**1.99%**	**0.20%**	**2.20%**
Direct Lending Return (EUR)	8.50%	8.50%	8.50%	8.50%	8.50%
Forward Hedged Direct Lending Return (LCCY)	**11.48%**	**9.84%**	**10.49%**	**8.70%**	**10.70%**

2. Source: CNBC.com, Jul-19 | 3. Source: TheGuardian.com, Jul-19 | 4. Source: FT.com, Jul-19 | 5. Source: Record Currency Management, Jul-19

Geopolitical Tensions[6]

Recent months have seen an escalation in tensions between the US and Iran, with the UK's seizing of tankers fuelling the situation. This adds to the list of existing global issues, the largest of which remains the Sino-US trade wars. Against the backdrop of escalating international disputes, Bund yields are ~30bps lower across the curve than a month ago (see Government Bond Rally). **We continue to monitor geopolitical tensions and to avoid direct commodity exposure.**

Spanish Elections[7]

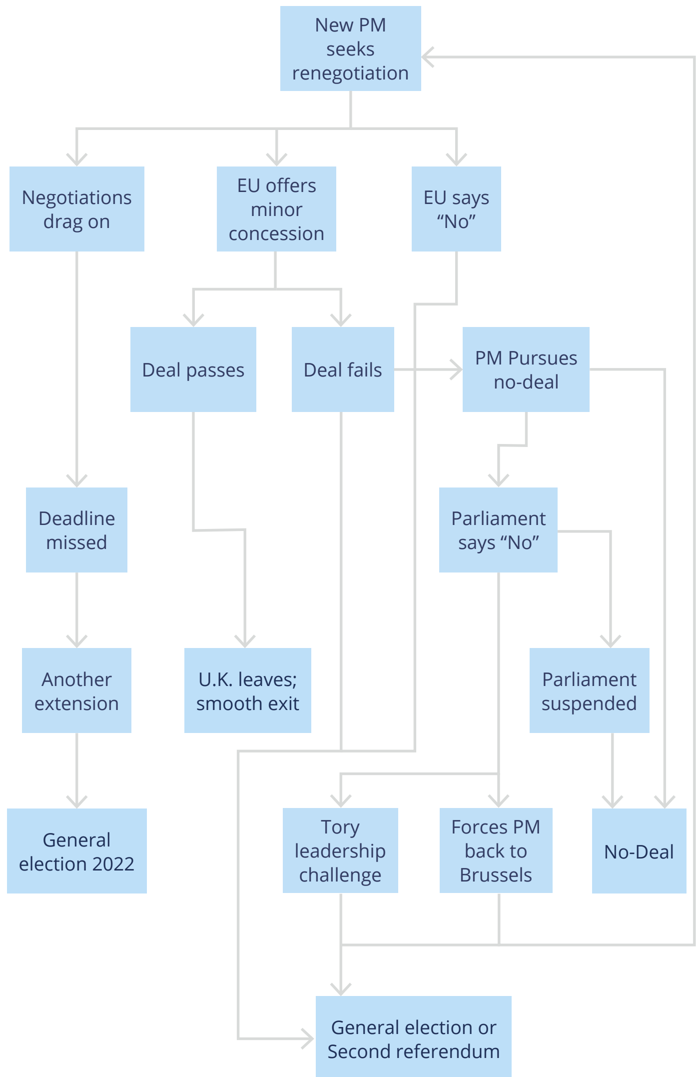
Socialist leader Pedro Sanchez is still trying to form another government following inconclusive elections in April. **We believe a socialist government is priced in, and that both a coalition with centre-right Ciudadanos and a more market friendly left-wing coalition remain upside possibilities.**

Italian Elections

The resignation of Guiseppe Conte as Prime Minister has triggered a fresh round of political positioning in Italy. Despite that, 10-year Italian bond yields have dropped to a historic low as political uncertainty has been offset by expectations of increased QE. **We maintain a selective approach to deployment in Italy.**

Brexit

Boris Johnson's election as Prime Minister on 24th July has increased the probability of a hard Brexit. That said, there remain uncertainties about his ability to deliver a no-deal Brexit through the UK parliamentary system, given that the UK and the EU both have a vested interest in avoiding a no-deal Brexit. **We continue to apply a supplementary Brexit stress-test when modelling UK companies and monitor Brexit readiness across potential and existing investments.**



Source: Bloomberg.com, Jul-19

6. Source: FT.com, Jul-19 | 7. Source: France24.com, Jul-19

View from Origination[8]

Direct lending volumes remain solid while broadly syndicated leveraged loan (BSL) volumes are materially down year-on-year. Growth on the continent offset the decline in UK volumes, given ongoing concerns re Brexit and consumer confidence. Meanwhile, deployment across Pemberton's funds was c.€1.1bn in 2019 H1, flat on 2018. Given current pipeline, we expect H2 deployment to exceed the c.€600m in the H2 of last year.

Equity Volatility[9]

In August, the S&P 500 chalked up its longest streak of consecutive 1%+ absolute daily moves since the 4Q18 selloff. This started at the end of July when the Fed lowered rates less aggressively than market forecast and continued through $300bn of new US tariffs on Chinese imports, a weakening of the RMB and weak data from Europe. The CBOE Volatility Index (VIX) rose above 24, its highest level since January and comfortably above the low levels of volatility investors have become accustomed to in recent years. Despite rising volatility in public markets, private debt continues to insulate investors from the impact of technical factors not linked to the intrinsic value of assets.

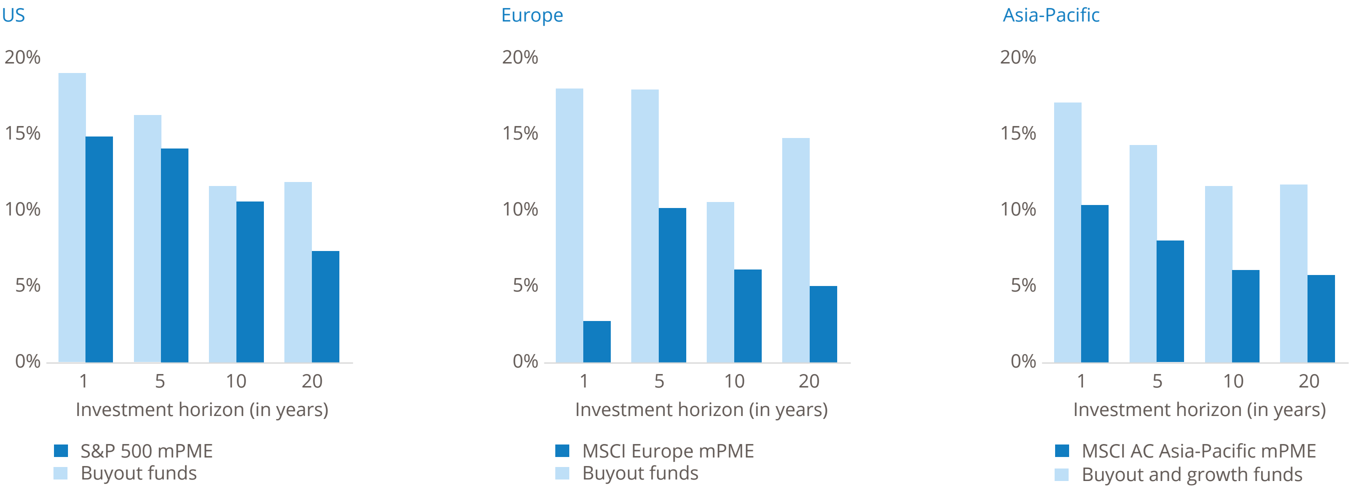
Government Bond Rally[9]

A sharp rally in government bonds saw the 30-year yield on US treasuries below 2% for the first time. The UK 30-year gilt also set a new record, falling below 1%. The debt of highly rated sovereigns such as the US, Germany and Switzerland has rallied particularly strongly, a sign of its status as a "safe-haven asset". The yield on the Barclays Global Treasuries Index has now fallen to 0.7% down from above 1.6% last Autumn. The move to safe-haven government debt is another potential indicator of anticipated volatility in public equity and credit markets.

Private Equity Performance[10]

Given rising multiples for sponsor-backed deals, it is helpful to evaluate how well PE funds have managed to deploy capital. As the below chart shows, European PE investors continue to materially outperform the public markets (and by significantly more than their US and Asian peers). We expect the share of PE-owned mid-market companies in Europe to continue to increase in the coming years.

End-to-end pooled net IRR (as of June 2018)[10]

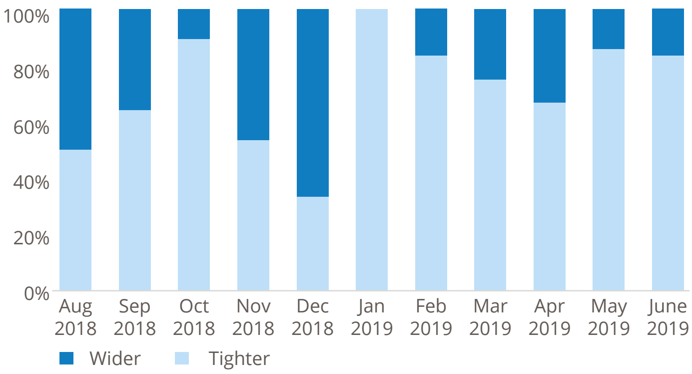


8. Source: Internal Pemberton Pipeline | 9. Source: FT.com, Aug-19 | 10. Source: Bain Global Private Equity Report, 2019

Institutional Market Supply / Demand[11]

Market supply-demand remained borrower friendly in Q2. Against a backdrop of record half-year CLO volumes and with institutional loan issuance down 40% year on year, ~75% of 2Q19 deals that were flexed moved in the borrower's favour. This is in stark contrast to last year, particularly 4Q2018 where the broad asset wide sell-off led to an investor friendly environment. Strong technicals have triggered a wave of issuance in recent weeks.

Percentage of Institutional Flexes moving Tighter / Wider



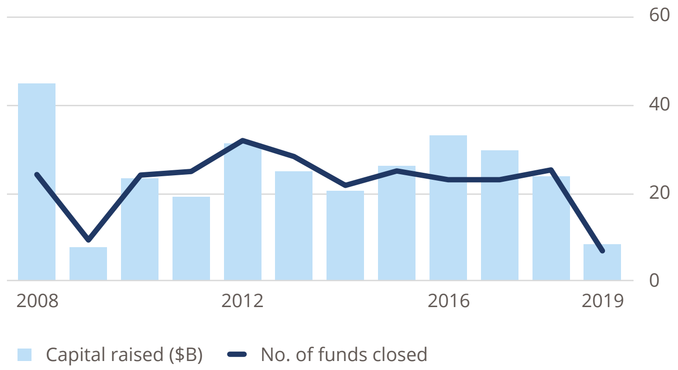
(Chart shows what % of all flexes done in each month moved yield higher or lower)

Source: LCD, an offering of S&P Global Market Intelligence

Defaults[12]

June 2019 represented the sixth consecutive month with no issuers in the S&P ELLI index currently in default. That said, both S&P and Moody's are calling for a pickup in the speculative-grade default rate, the latter predicting a 2019 figure of 3.0%. Recent defaults (outside the ELLI index) are concentrated in sectors we are deliberately cautious on (such as fashion retail and construction), while low default rates are reflective of a supportive macro environment. Against this backdrop, the below chart[13] shows how this is taking a toll on distressed debt fundraising globally. It should be noted that European default rates of 1.3% remain almost half those of the US at 2.8%.

No Distress – Fundraising for distressed debt has slowed



Preqin data. 2019 volume year-to-July

11. Source: LCD, Apr-19 | 12. Source: LCD, Aug-19 | 13. Source: Bloomberg.com, Jul-19

These are just a few thoughts based on our view of the market.

We'd love to hear your opinions. So please feel free to contact our Business Development team on BDgroup@pembertonam.com or +44 (0) 20 7993 9300 with any questions or comments.