PEMBERTON
Connecting Capital Across Europe

Pemberton Macro View

Safe harbours remain in the European mid-market

Q3 saw the ~75bp summer widening in syndicated loan markets completely reverse in the face of dwindling supply, negligible pipeline and record CLO issuance. However, recent market weakness has seen syndicated loan yields start to widen once again.

Against this backdrop, margins for direct lending, and covenant protections have remained firm, with a yield pickup versus syndicated loans of 4.7% in classic direct lending and a further 4.5% for more flexible solutions. In our view, the volatility in equity markets reinforces the case for direct lending, where substantial equity cushions and yield pick-up from High-Yield and syndicated markets remain.

MACROECONOMICS

- **Eurozone Economy** Eurozone growth slowed sharply in the third quarter as Italy stagnated and new emissions tests hit German car production. Year-on-year growth for the Eurozone came in at 1.7% for Q3, with forecasts for 2019 at 1.6% and 1.5% in 2020[1]. At a country level, growth in Europe is projected to be highest in Spain (2.3% in 2019, 1.9% in 2020) and lowest in Italy (1.0% in 2019 and 0.9% in 2020). **We believe this backdrop remains supportive for providing credit to leading mid-market companies.**
- **UK Economy** The growth outlook for the UK economy is under increasing pressure from Brexit uncertainty and faltering consumer purchasing power[2]. The EY ITEM club forecasts for 2018 UK growth were cut to 1.3% from 1.4% in July, citing a weakened outlook for real pay and higher oil and utility prices. Whilst the long-term outlook is more positive (1.5% in 2019, 1.7% in 2020 and 1.8% in 2021), risks are weighed to the downside. **We maintain a cautious view on the UK economy but there remain strong opportunities in the region.**

[1] Source: Bloomberg, Nov 18
[2] EY ITEM Club Autumn Forecast

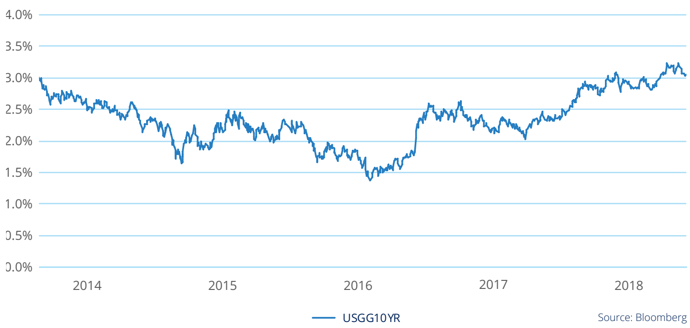
- **European Interest Rates** ECB policymakers have reiterated guidance for no rate increase until late 2019, despite ongoing US rate hikes. ECB President Mario Draghi has repeated previous comments that an economic slowdown was due to temporary blips that would not halt plans to end the €2.5tn QE programme by year-end[3]. However, recent weak GDP figures suggest further policy tightening will be contingent on upcoming data. Given all direct lending loans are floating rate and portfolio companies are contractually bound to hedge base rates, **rising rates should have a positive impact on fund returns.**

- **GBP Interest Rates & FX** There have been few developments in UK rates since the August rate rise, with the next movement expected in May or August 2019[4]. On a trade weighted basis GBP is little moved as Brexit negotiations have rumbled on. We expect little policy movement until there is further clarity on a potential Brexit agreement, which appears to be approaching pending parliamentary approvals. **We overlay a Brexit stress-test on all new UK investments and focus on UK borrowers with global revenues as part of a geographically diverse portfolio.**

- **US Interest Rates** Comments from Fed chair Jay Powell that he was "very happy" with the "remarkably positive" economy, sent 10-yr treasury yields as high as 3.2%, a post-2011 high (see below). Policymakers have indicated a fourth rate rise this year in December, followed by another three 25bp increases in 2019. **We believe rising US rates will be a catalyst for raising rates in Europe and the UK, in a positive move for returns in direct lending.**

- **Cross-Currency Uplift[5]** **USD investors putting their money into European direct lending can currently capture a 0.51% "risk-free" pickup.** This stems from (1) being able to sell Euros and buy US dollars forward at a 3.31% return in the FX markets, and (2) the 0% floor in Euro denominated loans (see below).

US 10-YR RATES AT POST-2011 HIGHS



ILLUSTRATIVE DIRECT LENDING RETURN ADJUSTED FOR LOCAL CURRENCIES[6]

	EURAUD	EURUSD	EURGBP	EURJPY	EURCAD
6m FX Forward Implied Differential	2.76%	3.31%	1.44%	0.18%	2.68%
Illustrative Direct Lending Return (EUR)	8.50%	8.50%	8.50%	8.50%	8.50%
Illustrative Direct Lending Return (Local Currency)	11.26%	11.81%	9.94%	8.68%	11.18%

CROSS-CURRENCY PICKUP FOR NON-EURO INVESTORS[6]

	EURAUD	EURUSD	EURGBP	EURJPY	EURCAD
6m FX Forward Implied Differential	2.76%	3.31%	1.44%	0.18%	2.68%
6m LIBOR Differential	2.41%	3.13%	1.25%	0.34%	2.67%
XCCY Basis Pickup for non-EUR Investors	0.35%	0.18%	0.19%	–0.16%	0.01%
EUR Zero Floor Impact	0.33%	0.33%	0.33%	0.33%	0.33%
"Risk-free" Cross-currency pickup (inc. 0bp EURIBOR Floor)	0.68%	0.51%	0.52%	0.17%	0.34%

[3, 4] Source: FT.com, Oct 18
[5, 6] Source: Record Currency Management, Nov 18

POLITICS

- **Trade Wars** Chinese GDP growth slowed to 6.5% in the third quarter, a slight slowdown from 6.7% in Q2 and the lowest reading since early 2009. This is the first set of data released since Trump announced tariffs on $250bn worth of Chinese goods in July. 2019 GDP forecasts have been cut to 6.2%[7]. **Given the sell-off in Chinese equities, this is another area we are looking to for possible contagion, particularly through commodities, though the Fund's portfolio has little exposure to the region.**

- **Germany** Angela Merkel stood down as the leader of the CDU and will not run again as Chancellor in 2021. Given Merkel has consistently argued that the jobs of Chancellor and party leader should never be split, we consider it unlikely she maintains power until 2021. **Irrespective of leadership changes, Pemberton believes the German Mittelstand will continue to be an economic powerhouse within the European economy and an attractive source of direct lending deals.**

- **Brexit** Brexit remains a critical issue for European investors. Having now secured a deal with the EU on the terms of Brexit, and the associated transition period, Therasa May is drumming up domestic support ahead of a parliamentary vote for the withdrawal agreement on December 11th. **Pemberton continues to stress all UK investments for a hard Brexit ahead of commitment. A negotiated Brexit, rather than a cliff-edge no deal outcome, remains our expectation.**

- **Italian Budget** The League / Five Star coalition has proposed a revised budget with a 2.4% fiscal deficit in 2019, breaching debt reduction benchmarks agreed by all Member States. Discussions are ongoing with the EU, though Italy's president and Central Bank Governor have recently stressed the importance of respecting EU rules and a balanced budget[8]. Domestic support for staying in the EU remains strong. **Given the stagnant domestic economy, the budget standoff with the EU and the spike in government bond yields (see below), we maintain a selective approach to Italy.**

SPIKE IN ITALIAN 10-YR GOVERNMENT BOND YIELDS

[7] Source: IMF, Nov 18
[8] Source: Reuters, Sept 18

MARKETS

- **View from Origination**[9] The competitive dynamic around deal processes is little changed, with increased competition in the upper end of private debt markets (€200m+) still visible. Meanwhile the dwindling forward calendar in syndicated markets has normalised, suggesting recent tightening is unlikely to continue. **Our strong origination network continues to be well-placed to find investment opportunities in local markets to protect from competitive dynamics in syndicated markets.** Meanwhile secondary prices in High-Yield have sold off, with a ~100bp uplift in YTMs in Europe in recent weeks.

- **Global Equity Market Sell-off** Global equity markets are materially off from Q3, with the NASDAQ Composite, a global benchmark, down nearly 10% (see below). The broad sell-off has been attributed to rates rising faster than expected in the US (ironically on the back of sustained economic growth), ongoing trade wars and EU tensions. Meanwhile in China, the Shanghai Composite continued its downward trajectory, heading for its longest run of monthly losses since 1982, and is currently trading near a 4-year low. Further, US equity benchmarks have recently joined European counterparts in negative territory for the year. **While softening equity valuations reflect increased macro risks, we consider credit conditions in Europe to remain relatively benign.**

NASDAQ COMPOSITE GLOBAL EQUITY INDEX SELL-OFF

- **Syndicated Market**[10] YTD new issue European volumes of €95.2bn stand 14% behind the same period in 2017, which was a post-crisis record for issuance on a full-year basis. In Q3 2018 total leverage rose to 5.6x, the highest since early 2008 and up from 5.3x in the prior quarter. Single-B spreads have tightened materially from summer highs, with credits pricing at ~E+350bps.

Against this backdrop, issuers are looking at re-pricings with €22.8bn notional outstanding with spreads of E+400bps or higher and trading above par. Of these, more than half are already out of their call period. Given just €9.1bn of repriced volume YTD (compared to €74.0bn in all of 2017), the market is braced for a wave of prints. **Note that mid-market spreads were little moved through the summer widening and subsequent tightening in syndicated markets.**

[9] Source: Pemberton Head of Origination, Internal Pemberton Pipeline
[10] Source: LCD, Nov 18

- **Defaults**[11] Just one constituent of the S&P ELLI is currently in default (Prezzo), representing a record low 0.11% of principal on a lagging 12-month basis. This is down from 0.12% last quarter and 1.1% as of December 2017. This is the lowest reading for the default measure since 2008 as compared to a maximum of 10.5% in December 2009. **The sustained low default rates reflect a benign environment for credit.**

[11, 12] Source: LCD

- **Mid-Market Covenant Protections** In the US, Janet Yellen recently warned of the "systemic risks" arising from leveraged loans. Weaker maintenance covenants in the syndicated TLB market are well documented (89% YTD issuance is cov-lite in Europe[12]) but the erosion of key protections, including asset transfers and collateral sales, are impacting the outlook for recovery rates. **Crucially, we are not seeing the same deterioration across lender protections in the European direct lending market.**

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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.