



The Q1 Bounce Back

PEMBERTON MACRO VIEW
Q1 2019

Q1 2019 saw a broad rally across asset classes to levels last seen before the sell-off in Q4 2018. The ~40% round trip in global equity aggregates was barely felt in European direct lending margins, reinforcing the stability of the asset class through otherwise volatile periods.

Whilst we note that US direct lending spreads moved wider with market volatility, we still see an attractive pick-up for investors in Europe, particularly in an environment where European default rates continue to track at half the level being seen in the US.

Lastly, we continue to see opportunities for direct lenders to increase market share as on-off banking mergers (such as Commerz-DB) distract banks.

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Eurozone Economy¹

The Eurostat flash estimate for Q1 2019 GDP came in at a surprisingly strong 0.4%, up from 0.2% in Q4 2018. Further, data suggests that strong performance is spread across the major economies with Italy emerging from recession, Spain growing at 0.7% and France at 0.3%. **We maintain our view that recent concerns around European growth reflect short-term factors rather than structural issues. The Bloomberg consensus continues to forecast low growth and a benign credit environment for 2019 and 2020.**

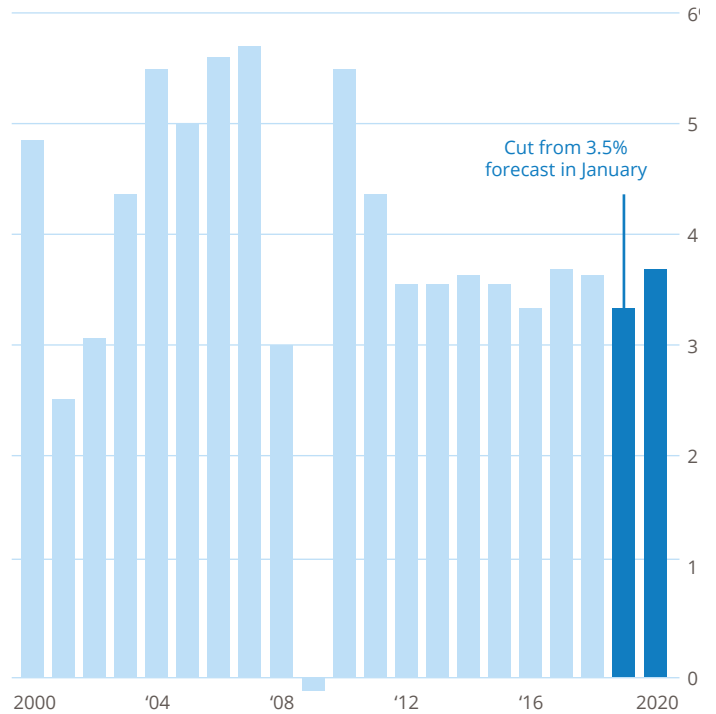
Global Growth

The IMF cut its outlook for global growth for the third time in six months. The revised 3.3% projection for 2019 would be the weakest since 2009 when the world economy shrank (and down from a 3.5% projection in January). After recovering in the second half of the year, global growth is then forecast to reach 3.6% from 2020. Please see the chart to the right for historical reference points. **We believe global growth above 3.0% is supportive for European credit.**

Lowest since the financial crisis

The IMF cut its outlook for 2019 global growth to 3.3 percent

■ Annual GDP (YoY) ■ Forecast



Source: International Monetary Fund

1. Source: TheGuardian.com, Apr-19



UK Economy

Despite the uncertainties, the UK economy continued to grow in February as manufacturers stockpiled goods ahead of an anticipated March Brexit. The Office for National Statistics said GDP grew by 0.2% in February from the prior month, ahead of market consensus. Further, industrial production jumped by 0.6% during February, driven by a 0.9% increase in manufacturing. This is especially positive given recent ONS warnings that Brexit concerns were holding back corporate investment in the UK. **We maintain disciplined around our UK exposure as part of a balanced pan-European portfolio. We view BoE measures (e.g. 100-day liquidity provisions vs usual 30) as constructive in case of Brexit volatility.**

European Interest Rates²

Following on from a surprisingly dovish tone through Q1, the ECB said in April it will keep interest rates at their record low "at least through the end of 2019". Whilst previous expectations had been for a rise in rates towards the end of 2019, recent GDP figures had pointed towards a more cautious approach to normalising conditions. **We consider a sustained low-rate environment with moderate growth as relatively benign for European credit.**

GBP Interest Rates & FX

UK 10 year swap rates rose by ~15bps on the back of stronger than expected Feb productivity data. This is against the backdrop of the search for Mark Carney's replacement (he leaves the post in Jan 2020). Meanwhile the value of Sterling continues to fluctuate with Brexit news but remained relatively stable following the announced extension. **We continue to expect little policy movement until there is further clarity on a potential Brexit agreement.**

US Interest Rates³

In contrast to the hawkish tone at the end of last year, Fed Reserve officials have begun discussing publicly the possibility of rate cuts ahead of upcoming meetings. Chicago Fed President Charles Evans said on 15th April "If core inflation were to move down to let's say 1.5%... that would naturally call for a lower funds rate". For reference, core inflation moderated to 1.8% in January from above the 2% target last summer. **Despite US rates falling from November highs (10 year down from 3.2% to 2.5% as of writing), the pickup vs EUR rates remains above 3% for US based investors in European Direct Lending.**

Cross-Currency Uplift⁴

USD investors putting their money into European Direct Lending can currently benefit from a 3.05% additional return through the FX forward markets (see below).

Illustrative direct lending return adjusted for local currencies

	EURUSD	EURGBP	EURAUD	EURJPY	EURCAD
6m FX Forward Implied Differential	3.05%	1.28%	2.34%	0.20%	2.20%
Direct Lending Return (EUR)	8.50%	8.50%	8.50%	8.50%	8.50%
Forward Hedged Direct Lending Return (LCCY)	11.55%	9.78%	10.84%	8.70%	10.70%

Italian Budget⁵

Back in December 2018, the European Commission refrained from starting disciplinary steps against Italy over its growing debt following last minute concessions over their proposed budget. Since then, the national debt in Rome has risen higher than anticipated by Brussels (132.2% of GDP vs 131.1% predicted). The EC will reassess Rome's compliance with EU fiscal rules, including the requirement to cut debt, in June on the back of the new data.

While Italy's 10-year government bond yield jumped to recent highs, markets have not reacted materially to recent developments (see chart to the right). Further, S&P affirmed Italy's credit rating at BBB (negative outlook), considered an important technical for markets. **We maintain a selective approach to deployment in Italy, remembering that in contrast, overall debt in the Eurozone fell to 85.1% of GDP last year from 87.1% in 2017.**

Italian 10 year Gov. Bond Yields



Source: Bloomberg

Trade Wars

Following on from previous academic work, the ECB have published a paper suggesting that GDP growth would drop more sharply in the US than in China should tariffs and other barriers be implemented as part of ongoing trade tensions. Amid rumblings that Europe may be dragged into the conflict (on the back of alleged subsidies for Airbus), the paper also found that Europe would suffer less than the US. **Following threats of further US tariffs on Chinese goods, we continue to monitor the rhetoric and potential market impact of ongoing discussions.**

Spanish Elections⁶

The Socialist Party (PSOE) secured 123 seats out of 350 (29%), short of an outright majority but much better than the 85 seats it secured in 2016. It is thus likely that the incumbent Socialist PM should be able to form a left-wing coalition, likely with the backing of far-left Podemos. Given members of a potential coalition included bank levies and taxes on Real Estate Investment Trusts (Socimis in Spain) in their manifestos, a socialist coalition is likely to hurt financial stocks in the region. **Whilst a left-wing coalition is largely priced in, we believe a combination with centre-right Ciudadanos remains a possibility that would be well received by markets.**

Brexit

In mid-April, European Union leaders agreed to delay Brexit until October, averting a no-deal withdrawal with less than 48 hours remaining. This was in-line with Pemberton expectations. Following rumours of a leadership challenge after the third rejection of her proposed deal in parliament, Theresa May agreed to step down once Brexit has been delivered. There are rumblings of a **fourth** vote on a revised deal⁷, this time with the Irish backstop removed entirely, with a view to showing EU leaders that the deal would be passed should they make that concession. On a micro-level, discussions with borrowers suggest that they are learning to live with the uncertainty and have made contingencies for tariffs, supply chains, and FX. **P.E. activity in the UK was 34% lower YoY in Q1 2019. (Source: KPMG). We continue to apply a supplementary Brexit Case when modelling UK companies. We believe a negotiated exit remains the most likely outcome.**

View from Origination⁸

We continue to see an opportunity for direct lenders to take market share from banks as they reduce single name exposures (Nordics) or focus on strategic change (the on-off merger talks at Commerz and DB).

Global Equity Market Recovery

Global equity markets have now completed a remarkable turnaround from the sell-off in Q4, with the ~20% reversing entirely and the Nasdaq Composite Global Aggregate back at the highs seen in 3Q18. This is despite recent IMF cuts to global forecasts for growth. **As with debt markets, the impact of public market volatility in equity benchmarks has been dampened in private equity valuations with little readthrough to our LBO valuations.**

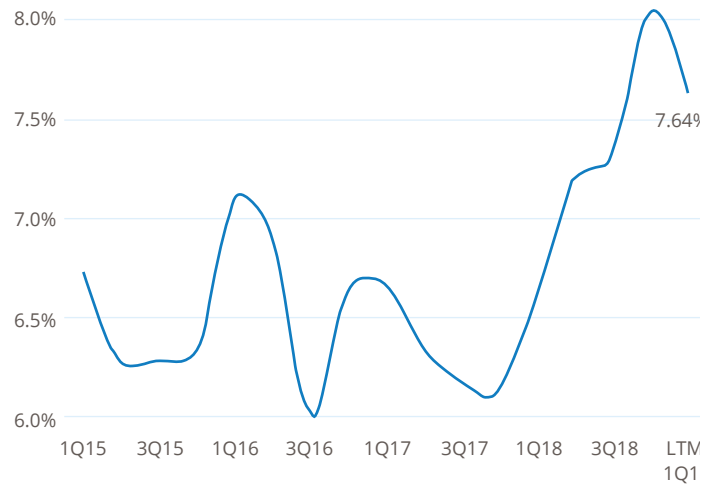
NASDAQ Composite Index Recovery



US mid-market⁹

US mid-market (defined as sub-\$50m EBITDA) yields have materially widened over the last 12 months (see chart), in line with the US leveraged loan market. Whilst the US mid-market pick-up has remained around 1% versus syndicated debt, **European direct lenders continue to capture a 2.5-3.5% pick-up versus European syndicated benchmarks.**

YTM for deals <\$50m EBITDA, US only



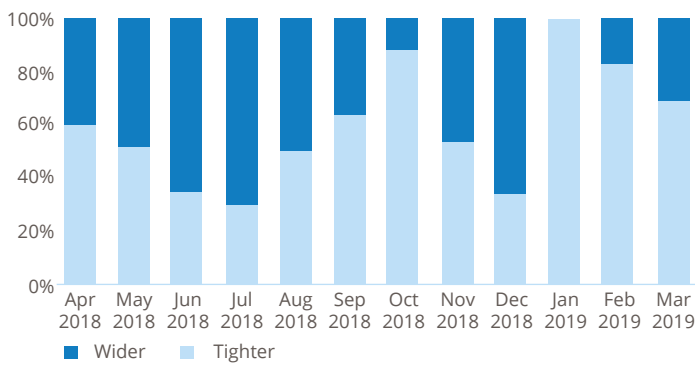
8. Source: Pemberton Head of Origination, Internal Pemberton Pipeline
 9. Source: LCD, Apr-19



Institutional Market Supply / Demand¹⁰

2018 was a record year for CLO issuance in the 2.0 era. Building from that, €6.9bn has printed in Europe 2019 YTD, which is 11% ahead of the same period last year. This compares to €20.4bn of new-issue syndicated leveraged loan volume YTD which is ~40% down on the same period in 2018. Thus, the LCD metric for syndicated **market supply-demand remained borrower friendly through Q1**, reflected in the ~80% of flexed deals that went tighter rather than wider – see chart.

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

Defaults¹¹

March 2019 represented the third consecutive month with no issuers in the S&P ELLI index currently in default. This is down from 0.12% (of principal outstanding) as of year-end and 1.1% as of December 2017 and compares to a maximum of 10.5% in December 2009. 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% in 2019. Nonetheless, a spate of recent insolvencies is something we are monitoring closely, including administration at FlyBMI, LK Bennett and House of Fraser. **It should be noted that European default rates of 1.3% remain almost half those of the US at 2.8%.**

10. Source: LCD, Apr-19 | 11. Source: LCD, Apr-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.

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