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PEMBERTON
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Pemberton Macro View

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Big Wheels Keep on Turning

A VIEW FROM PORTFOLIO MANAGEMENT: THE MACROECONOMIC DRIVERS IN PRIVATE DEBT

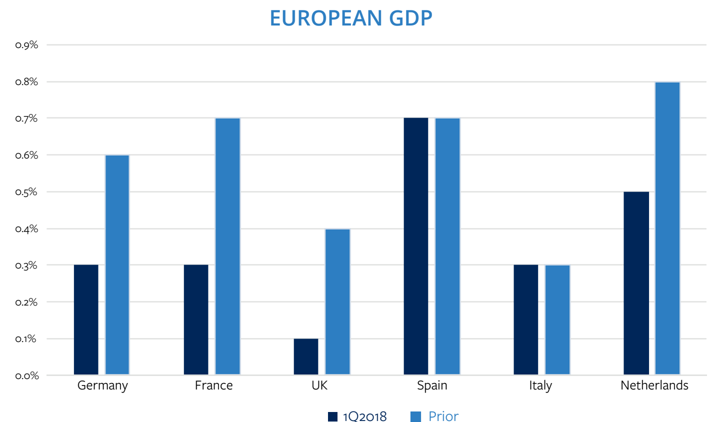
Despite concerns of rising populism in Europe and further afield, strong corporate earnings and a low default environment continue to be supportive for direct lending in Europe. The floating rate nature of the asset class provides further upside in a rising rate environment, with our borrowers contractually hedged against higher base rates. We are confident direct lending in Europe still offers compelling risk-adjusted returns for investors for the foreseeable future.

MACROECONOMICS

- ***European Interest Rates*** **– We believe we'll see the first ECB rate hike in Q2 2019, earlier than market consensus**, given anticipated rate hikes in the US and what we expect to be short-lived weakness in European GDP growth. Following the weaker GDP figures in Europe, the ECB may wait until July to announce an end to asset purchases, but we believe the US trends will ultimately be mirrored this side of the Atlantic. Either way, rising rates will hopefully reflect growth and benefit returns for direct lending funds given their floating rate nature.
- ***US Interest Rates*** **–** The Fed continued to slow its asset purchases. Following recent rate hikes in the US, the yield curve has flattened with short term rates approaching their longer term counterparts. This has historically indicated that a recession may be looming[1], though policy makers appear unconcerned. Whilst we consider long term yields to be underestimating rate hikes, especially given three anticipated increases this year, **the policy outlook continues to point to a benign US credit environment.** A slowdown in the US would likely spill over and impact European interest rate policy.

[1] Source: Reuters – "Flat yield curve a warning on recession? Fed economists disagree." – 5 March 2018

- ***European GDP –*** Growth slowed in Q1 with softer numbers from Germany (0.3%), France (0.3%) and the UK (0.1%). Spain numbers (0.7%) were more positive and in line with Q4 2017, with Italy (0.3%) also in line with the prior quarter. The slowdown has largely been attributed to storms ("Beast from the East") and has potential to impact the planned paring back of stimulus this year. In the UK, for example, a rate increase in May was previously considered a near certainty. The next increase is now not expected until Q3. **We expect European growth to recover after the one-off impact of the Beast from the East rolls off.**



Source: Bloomberg

POLITICS

- ***Italian Elections*** **–**The formation of the populist Five Star / League alliance has led to considerable volatility in Italian government bonds and Italian financial securities over recent weeks. In credit, we have seen Italian 10-year government bonds go from a yield of 1.75% in early May to a recent peak of 3.20% at the end of May (some 2.85% wider than German Bunds)[1]. In equities, we have seen the Italian MIB share index lose 10% of its value since its early-May highs[2]. **In our view, whilst there is clearly political uncertainty, we believe the recent stabilizing statements from the Italian Finance Minister (pro-Euro), the dynamics of the Italian political system (two branches of parliament with similar powers) and a broadly pro-Euro electorate are likely to prevent any cliff-edge changes** in the near term. Further, we believe the market continues to ignore the broad improvements in the legal framework as a lender in the jurisdiction. We believe that direct lending remains a safe harbour compared to fixed rate instruments, equities, or financial securities in the region.

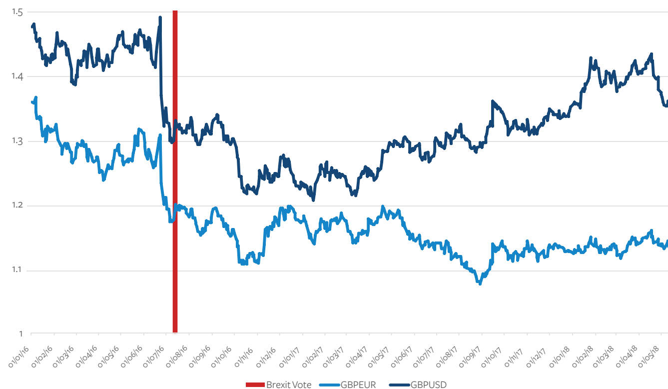
- ***Spanish Elections*** – In the ordinary course of business, a vote of no-confidence and a change in Prime Ministers, especially to one that only represents 24% of parliament seats, would have attracted more headlines. However, **we believe that the signing-in of Pedro Sánchez has quite rightly been met by unchanged markets in Spain. Spain has achieved GDP growth in excess of 3% for the last 3 years and Sánchez appears to offer more of the same**[4]**.**

- ***Trade Wars –*** Who would have predicted that the latest G7 meeting would see one of President Trump's top officials saying there was a "special place in hell" reserved for President Trudeau following the escalation in the global tariff spats. In response to the US taxes on steel and aluminium, the Bourbon and pork belly tariffs have received headlines, but it is really the escalation and the potential impact on the German auto sector that we are watching most closely. The value of passenger vehicles and parts imported by the US last year ($324bn) was more than 10x that of steel ($29bn)[3]. As Europe's largest exporter, Germany is the most exposed economy to these risks. However, **we remain optimistic that the grandiose posturing will not escalate into a materially damaging 'lose-lose' trade war.**

- ***North Korea –*** "I will surely and definitely tame the mentally deranged U.S. dotard with fire." Let's hope not. What a difference a few months make. Whilst the historic meetings have kicked-off in Singapore, there is a long way to go in removing the tail risk on the Korean Peninsula. To date, we believe that the Korean nuclear threat has only ever been tail risk. **We agree with one of Trump's latest tweets on the probable outcome –"We will be fine!"**

[1,2,4] Source: Bloomberg – 12 June 2018
[3] Source: FT – "Trump's car tariffs highlight threat of retaliatory trade war." – 24 May 2018

GBP PERFORMANCE VS EUR/USD



Source: Bloomberg

- ***Brexit –*** Conservative MPs have had their holidays cancelled until further notice as Theresa May tries to push through the latest parliamentary votes on how to negotiate Brexit (not even how Brexit will happen). Despite the mine-field that needs to be navigated, we believe that the recent progress on the transitional post-Brexit period and the status of EU citizens in the UK are signs that shared common interest in avoiding a hard Brexit will prevail. In our view Brexit will not result in a cliff event and will avoid the UK crashing out of the EU without trade agreements and associated provisions. **Further, in our view, credit and currency markets have already priced in a pessimistic view.**

MARKETS

- ***Public Earnings –*** The read from Q1 earnings season is strong with 81% of S&P 500 companies having reported earnings ahead of estimates so far. The corresponding number for the Eurostoxx is 61% and FTSE 77% though not all companies have reported[1]. **We consider the stronger than expected public earnings to be supportive of low default rates and spread tightening in the US and Europe, i.e. broadly positive for direct lending.**

- ***Oil –*** As oil approaches $80 a barrel, a level not seen since 2014, producers are reaping the benefits. US oil companies generate free cash at $53 a barrel[2]. Sustained rises in oil prices present a risk for growth, inflation and confidence. In Europe, consumer and business confidence is generally less sensitive to oil price fluctuations. **In that context, we do not consider rising oil prices likely to inhibit European growth or trigger policy rate rises.**

- ***Emerging Markets Risk –*** as in 1998, we are closely watching the impact that rising US interest rates have on EM currencies. We believe there is a risk that increasing US rates may lead to investors withdrawing from EM investments in order to invest in US dollars. For the most-part, **Europe's mid-market borrowers are largely immune from EM currency risk.**

- ***The Credit Cycle –*** Leverage multiples have been rising in loan markets. Since 2010 average debt / EBITDA ratios have risen by ~1.0x[3]. This has been mirrored in direct lending markets where we have seen multiples increase by 0.3x[4]. Whilst concerning at first glance, it is worth noting that **cash interest costs are materially lower, borrowers are contractually required to hedge against increasing base rates, and equity cheques have been increasing (see below).**

- ***Equity Valuations –*** Acquisition multiples have increased from 10.0x in 2016 to 11.1x in Q1 2018[5]. **We predict that the increase in multiples in the large cap market will spread to the mid-market and provide further downside protection for direct lenders.** We have been successful at keeping the average LTV of investments and pipeline at around 50%[6], suggesting that sponsors rather than lenders are bearing the incremental risk.

- ***Defaults –*** The lagging ELLI 12-month default rate by principal amount dropped from 1.24% in February to 1.17% in April, up slightly from 1.11% in Q4 2017[7]. **The trend in default rates supports our constructive view of the environment for spreads.**

- ***Sectors –*** We are particularly cautious on the following sectors given the current macro backdrop; (1) Businesses linked to discretionary consumer spending in the UK (fashion retail, casual dining etc.), (2) Businesses with material EM currency exposure through customers or contracts (i.e. Turkish Lira, Argentine Peso) and (3) non-ESG compliant businesses given the rise in ethical investing.

1 Source: Bloomberg –12 June 2018
2 Source: FT – "Oil price has sector's investors eyeing a windfall." – 22 May 2018

3, 5 Source: LCD – 3 April 2018
4, 6 Source: Pemberton Pipeline as at 12 June 2018
7 Source: LCD – 12 May 2018

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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 Investor Relations team on ir@pembertonam.com or +44 (0) 20 7993 9300 with any questions or comments.