Q3 2022

UBP PG - ACTIVE INCOME

Quarterly Comment

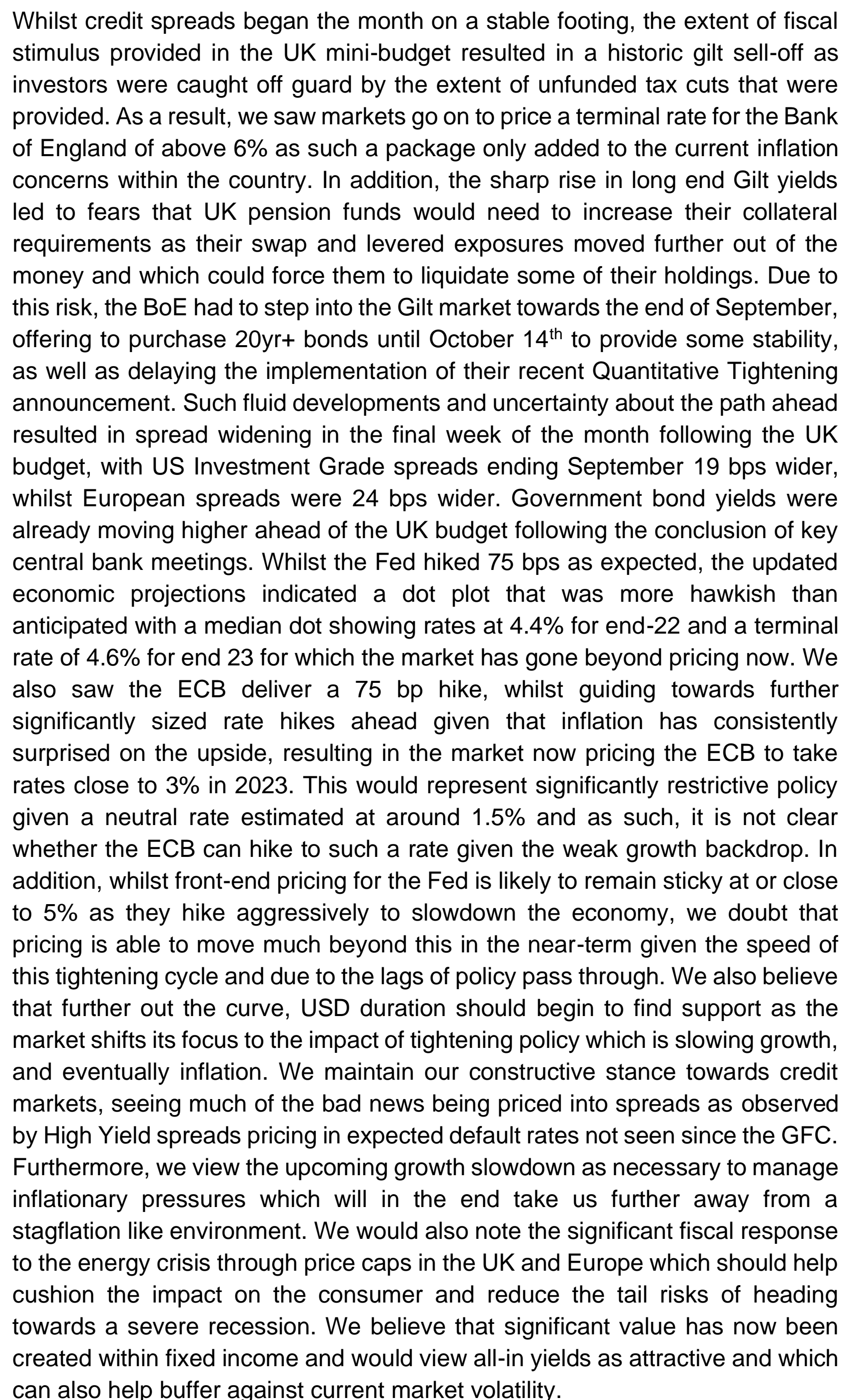
For Professional Investors in Switzerland or Professional Investors as defined by the relevant laws. The classification of the fund(s) as per the Sustainable Finance Disclosure Regulation (SFDR) is available on ubp.com or in the latest prospectus.

Market Comment

- **Private debt markets:** 2022 has thrown a new set of challenges at investors and the global economy. We are witnessing a substantial regime shift towards a world of higher inflation, less potent policy makers and a transition towards a multi-polar economy. The primary issuance of high yield bonds and syndicated loans has slowed down over the summer and while we saw a small volume of syndicated loans issuers coming back to the market in September, volumes continue to remain very low. Banks have a reduced risk appetite as a result of lending commitments made earlier this year that they have not yet been able to place. Direct Lenders have stepped in to fill this void providing a reliable source of financing for Private Equity sponsors. This leads to further improved margins and original issue discounts (OIDs) as well as lower leverage levels and more lender friendly documentation, including covenants for investors in the Primary Direct Lending market.
- **Public debt markets:** Despite the growth and inflation concerns mentioned above, credit spreads performed well in July, supported by the decline in real rates observed. US Investment Grade spreads for example tightened by 14 bps and European spreads by 30 bps, with European outperformance observed despite ongoing concerns in relation to gas security as supply through the Nord Stream pipeline was reduced, which highlights to us how much pessimism is already being priced into the market. Furthermore a cleaner technical backdrop from a positioning perspective appears to have supported credit markets over the past month, coupled with limited corporate issuance observed. We continue to hold a positive bias towards credit, given attractive valuations at a time when the market is pricing in a significant rise in default rates in the high yield market for example, which is not our base case amid a still resilient growth backdrop. Financial conditions also managed to ease following both Fed and ECB meetings in July which were not as hawkish as feared and supported risk markets more generally. At the Fed for example despite the 75 bps hike, investors took relief from Fed Chair Powell's press conference in which he spoke of taking policy only moderately restrictive and also that as policy tightens, it will likely become appropriate to slow the pace of tightening. At the ECB, although they surprised with a larger than expected 50 bps rate hike, President Lagarde emphasized that this was a frontloading of monetary tightening, rather than a change in their estimates for the terminal rate. The larger hike was also made possible due to the creation of the Transmission Protection Instrument (TPI) which should help alleviate peripheral debt concerns ahead of Italian snap elections, as a new government will likely stick to the conditionality required for access to the EU Recovery Fund and the TPI. Developments herein allowed for government bond yields to decline significantly in July by 36 bps for US 10 year bond and 52 bps for German 10 year bonds in what were curve flattening moves given the frontloading of hikes

observed. Following the government bond rally of July, we saw yields at the beginning of August as being at the bottom end of the recent range and saw room for yields to move higher, especially ahead of the payroll report for August. This report printed very strongly with payrolls more than double the consensus at 528k and resulted in a sharp hawkish repricing of the Fed. As a result, the market was pricing in the Fed's terminal rate above its own estimate for the 2022 median dot which led us to shift to a more neutral stance on duration whilst we wait for further data to be released.

- Credit spreads and risk markets more generally had a weak end to August as the market digested the hawkish communication received from both the Fed and ECB at Jackson Hole. Fed Chair Powell in his eagerly awaited speech focused his message on managing inflation over growth, where he said that higher rates to slow growth and bring down inflation will also bring some pain to households and businesses. Although Powell reiterated comments from the last press conference that at some point it will likely become appropriate to slow the pace of rate increases, he also added that restoring price stability will likely require maintaining a restrictive policy for some time which is another example of the Fed pushing back against rate cuts priced in for 2023. Jackson Hole was also a forum for the ECB to shift its policy in the more hawkish direction given Isabel Schnabel's speech, in which she said that policy needs to respond more forcefully due to uncertainty about the persistence of inflation, the threats to central bank credibility and the potential costs of acting too late. Comments herein were followed by several other ECB members backing a larger 75bp hike for the September meeting, for which the market went on to price. If anything, it was communication from the ECB that caught markets more off guard and led to an underperformance of EUR rates versus USD rates, as German 2 year yields rose by a significant 92 bps during the month with the curve flattening, whilst the move higher in USD front-end rates was also large at 66 bps on the two year rate. Moves herein were also supported by a further rise in European natural gas prices as the Nord Stream pipeline was shut again by Russia, driving short term inflation expectations higher within the Eurozone which could have led to this shift in ECB communication described. As a result, the ECB is currently priced for a terminal rate of 2.4% and the Fed of around 4% which are both well in restrictive territory. We therefore think that holding interest rate duration makes sense given what is now priced, as well as it being able to provide protection for portfolios if the market shifts its focus back onto growth concerns, as inflation is set to decline over time. For credit, European rates and energy price developments described here led to an underperformance of European credit versus US credit this month, with the latter also managing to benefit from a more resilient growth backdrop. EUR investment grade credit for example widened by 14 bps in August, whilst USD credit spreads in contrast tightened by 6 bps despite the unusual heavy corporate issuance observed for this time of year. We maintain our constructive stance towards credit markets, seeing much of the bad news being priced into spreads and viewing the growth slowdown as necessary to manage inflationary pressures. We believe that significant value has been created within fixed income and would view all-in yields as attractive and can also help buffer against market volatility and growth fears.
- Actions from policymakers drove significant volatility within rates markets in September which had a knock on effect for credit and risk more generally.



Whilst credit spreads began the month on a stable footing, the extent of fiscal stimulus provided in the UK mini-budget resulted in a historic gilt sell-off as investors were caught off guard by the extent of unfunded tax cuts that were provided. As a result, we saw markets go on to price a terminal rate for the Bank of England of above 6% as such a package only added to the current inflation concerns within the country. In addition, the sharp rise in long end Gilt yields led to fears that UK pension funds would need to increase their collateral requirements as their swap and levered exposures moved further out of the money and which could force them to liquidate some of their holdings. Due to this risk, the BoE had to step into the Gilt market towards the end of September, offering to purchase 20yr+ bonds until October 14th to provide some stability, as well as delaying the implementation of their recent Quantitative Tightening announcement. Such fluid developments and uncertainty about the path ahead resulted in spread widening in the final week of the month following the UK budget, with US Investment Grade spreads ending September 19 bps wider, whilst European spreads were 24 bps wider. Government bond yields were already moving higher ahead of the UK budget following the conclusion of key central bank meetings. Whilst the Fed hiked 75 bps as expected, the updated economic projections indicated a dot plot that was more hawkish than anticipated with a median dot showing rates at 4.4% for end-22 and a terminal rate of 4.6% for end 23 for which the market has gone beyond pricing now. We also saw the ECB deliver a 75 bp hike, whilst guiding towards further significantly sized rate hikes ahead given that inflation has consistently surprised on the upside, resulting in the market now pricing the ECB to take rates close to 3% in 2023. This would represent significantly restrictive policy given a neutral rate estimated at around 1.5% and as such, it is not clear whether the ECB can hike to such a rate given the weak growth backdrop. In addition, whilst front-end pricing for the Fed is likely to remain sticky at or close to 5% as they hike aggressively to slowdown the economy, we doubt that pricing is able to move much beyond this in the near-term given the speed of this tightening cycle and due to the lags of policy pass through. We also believe that further out the curve, USD duration should begin to find support as the market shifts its focus to the impact of tightening policy which is slowing growth, and eventually inflation. We maintain our constructive stance towards credit markets, seeing much of the bad news being priced into spreads as observed by High Yield spreads pricing in expected default rates not seen since the GFC. Furthermore, we view the upcoming growth slowdown as necessary to manage inflationary pressures which will in the end take us further away from a stagflation like environment. We would also note the significant fiscal response to the energy crisis through price caps in the UK and Europe which should help cushion the impact on the consumer and reduce the tail risks of heading towards a severe recession. We believe that significant value has now been created within fixed income and would view all-in yields as attractive and which can also help buffer against current market volatility.

All performance figures are given net of fees. Past performance is not a guide to current or future returns. See full disclaimer at the end of the document.

Performance Review

- In Q3, UBP PG Active - Income decreased -0.4% net of fees, (I Share class).
- Before fees, the Private Debt allocation delivered -1.6% and the Public Debt allocation delivered -6.7% since the beginning of the year.

Portfolio Activity

- At the end of the quarter, the yield of the portfolio in USD was 11.7%.
- The interest rate exposure 0.7 years
- The overall credit allocation was:
    - Private debt: 58%
    - Public debt: 42%

- As of 30 September 2022, Partners Group Active Income S.C.A., SICAV-SIF held an active portfolio of investments in 35 companies broadly diversified across countries and industry sectors. In a market with currently slower transaction activity, the Partners Group Active Income S.C.A., SICAV-SIF portfolio successfully realized below investment VetCor Professionals Practices LLC and continues to evaluate new investment opportunities with high conviction names and improved conditions as mentioned in the market overview.
- **Vetcor**: The Fund fully realized its investment in VetCor Professional Practices LLC. The investment was first provided to VetCor in 2018 to support the company's recapitalization. Since the initial investment, the company has expanded its regional footprint from 270 veterinary hospitals across 28 US states to 549 hospitals across 40 US states and Canada. Founded in 1997, VetCor is an operator of veterinary practices in North America. VetCor provides management, training, and administrative support to its hospitals while its facilities offer a full range of general medical and surgical services for pets as well as pharmacy and ancillary services such as boarding, grooming, and other pet products.

Outlook

- **c** In the current market environment, the Private Debt asset class continues to be highly attractive, having shown resilience in 2022 by outperforming all other fixed income and equity indices. While stocks and bonds registered negative returns over the third quarter 2022, both the syndicated loan and direct lending market generated positive performance, due to the floating rate nature of the asset class. With the inflation running well above target, the asset class should continue to benefit from further increases in interest rates by Central Banks. We focus mainly on senior secured investments on the safest part of the capital structure. As our portfolio companies are industry leaders with strong EBITDA margins and cash flow generation, they will be able to handle future economic headwinds..

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