

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.** The first quarter of 2023 was marked by continued rate volatility, heightened inflation, and macro uncertainty. Despite these factors, markets rallied broadly in the first quarter and offset losses seen in 2022. After outperforming most asset classes in 2022, Private Debt experienced another strong quarter, with the US loan market up 3.2% and the European loan market up 3.9%. Private Debt issuance remains low due to the persistent slowdown in M&A activity. For investments that have come to market, we continue to see LBO sponsors leaning much more heavily on the direct lending market rather than syndicated loans. While net new loan issuance fell, gross syndicated loan issuance did increase in Q1 due to a large uptick in amend-to-extend transactions. These investments allow borrowers to push out their maturities to help weather near-term headwinds, whereas lenders benefit through improved economics on the amended loans. As of the end of Q1 2023, just 4% of the \$1.4 trillion US and 6% of the €2.8 billion European syndicated loan market are set to mature before 2025
- Public Debt.** The first month of 2023 brought additional positive news on inflation and, to some extent, better than expected news on the growth front. This led to an upward revision in the economic outlook for some countries which, coupled with the reopening of China, improved the general sentiment on the global economic outlook and upward revisions in forecasts by institutions such as the International Monetary Fund. On activity, PMIs highlighted more resilient economic growth in the Eurozone while the economic momentum eased further in the United States and the United Kingdom. China's activity also improved across sectors on the back of the combined effect coming from the country's reopening and the Lunar new year holiday. On inflation, January provided further evidence of easing price pressures, driven by lower energy prices and contracting demand. Meanwhile, core inflation remains elevated, well above central bank's target, and while some signs of easing wages and core price pressures (excluding rents) have emerged in the United States, the Eurozone and the United Kingdom seem to be facing stickier core inflation. Across developed markets, headline inflation is expected to continue to trend downward, while core inflation should remain robust across developed markets throughout this year, largely supported by service prices and wages. We continue to believe that a large chunk of the impact from higher rates still needs to be felt across most economies. What's more the labour market is still lagging behind, remaining extremely tight and providing support to households meaning more slack is needed. Even in the US where the economy has been weakening, the latest payrolls report provided further evidence of the strength in the labour market. The outlook for the US economy seems to be pointing to a slowing economy and slowing inflation and a path towards a soft landing, but volatility in key indicators including non-farm payrolls and ISM services numbers keep

uncertainty elevated. The outlook looks even more uncertain in the Eurozone where core price pressures remain elevated, and the economy has so far proven to be more robust than what anticipated. As rates rise further and the impact of tighter monetary policy kicks in, advanced markets should experience a slowdown in activity later this year. At a global scale, growth should remain resilient though, largely supported by Asian economies.

- 2023 has begun on a strong footing for fixed income with both interest rate and credit markets rallying in January. Positive risk sentiment was driven by a re-rating of global growth expectations as China's economic reopening appeared to be taking place faster than anticipated, whilst the Eurozone economy was deemed as being less at risk of suffering from blackouts following the sharp decline in natural gas prices. In addition, positives were also seen on the inflation front as US headline and core inflation continued its decline, whilst wage growth pressures abated further, as highlighted by the fall in the Employment Cost Index. As a result, credit spreads were supported in January despite the heavy supply which came to the market, highlighting the strength in demand and the cash that was ready to be put to work. For example US Investment Grade spreads tightened by 14 bps during the month whilst EUR spreads tightened by 20 bps in moves that were a continuation of the trend observed in Q4. We entered 2023 maintaining our positive bias towards credit markets, viewing growth as slowing rather than collapsing and with the market overly pessimistic with regards to expectations for recession. As the range of possibilities for the Fed's terminal rate narrowed, we expect this to keep rates volatility capped, where reduced uncertainty herein could support inflows back into credit markets and support spreads. We view corporate fundamentals as starting the year in a healthy position, bank balance sheets strong with earnings benefiting from the higher rates backdrop and with valuations attractive. Interest rate markets also rallied in January as inflation pressures appeared to decline which all but confirmed that the Fed would be stepping down its hiking pace once again at the February meeting, down to 25 bps. As a result, US 10 year yields declined by 37 bps during January whilst the comparative German yield declined by 29 bps, with the latter underperforming given that the market was still digesting the increasingly hawkish communication from President Lagarde at the December ECB meeting.
- February provided further evidence of growth resilience while it brought renewed concern on the inflation front. Inflation surprised on the upside in several countries including the Eurozone and the United States while it fell by more than expected in few (United Kingdom and Canada). Japan also provided evidence of broadening price pressures. While energy inflation eased further, food and service prices (largely driven by wages) continue to put pressure on developed economies inflation prints. Producer prices remain below their 2022 highs and their annual growth remains on a downtrend but are still elevated. Recently, the ISM manufacturing prices paid index went back into expansion territory signalling rising cost pressures on producers. Such volatility in monthly data highlights the risks of having a less linear downtrend in inflation and stickier core price pressures in the first half of the year. In some economies, this is translating in core inflation being above headline inflation. As base effects on energy and food become more favourable from March onwards and weather gets warmer, we expect headline inflation to continue to trend downward. Meanwhile, core inflation should remain robust across developed markets



throughout H1, largely supported by service prices and wages, and ease only in the second half of the year. On activity, PMIs highlighted sustained resilient economic growth across major economies. Strong services activity offset weakness in the manufacturing sector and enabled a rebound of private economic activity growth in recently underperforming economies such as the United States and the United Kingdom. Across developed markets, we continue to believe that a large chunk of the impact from higher rates still needs to be felt. The labour market is still lagging behind, remaining extremely tight and providing support to households meaning more slack is needed. We continue to expect the US economy to slow as excess returns are depleted and consumers' and businesses exposure to rates intensifies. The labour market and ongoing recovery of the services sector remain key upside risks. In the Eurozone, we expect stickier core inflation pressures to mean rates higher for longer and greater pressure on consumers at a later stage. As rates rise further and the impact of tighter monetary policy kicks in, advanced markets should experience a slowdown in activity later this year. At a global scale, growth should remain resilient though, largely supported by Asian economies. China's activity recently surprised on the upside, improving across sectors and providing evidence of a robust economic recovery, which is likely to persist in the near term.

- Whilst January was a strong month for fixed income markets, February saw a reversal in fortunes for the asset class which was largely a result of the repricing of terminal rate expectations for both the Fed and ECB. Pricing for the Fed's peak terminal rate jumped by over 50 bps in February, with a similar trend witnessed for the ECB as expectations for the deposit rate rose 46 bps on the month, and this was largely as a result of the strong data mentioned above. In the US the focus was on the blowout payrolls report which led investors to believe that further hawkish policy is required to loosen the labour market. In the Eurozone attention turned to inflation trends in which prices are appearing stickier than had been hoped by ECB members, whilst resilient growth is also allowing the board to push for tighter financial conditions given reduced near-term recession risks. This repricing led curves to flatten aggressively globally, with the US 2 year vs 10 year yield for example flattening by 20 bps in February, with the 10 year yield rising by 41 bps during the month and the 10 year German Bund yield rising by a similar 37 bps. This latest repricing suggests to us that the rates sell-off is in a mature phase and hence we maintain our positive bias towards interest rate duration, favouring US duration in the belly of the curve. With the market now pricing a higher terminal rate for the Fed than the updated March dotplot is likely to show, we see valuations as attractive. This is especially as we expect for the disinflation trend to remain intact, and as it appears as though some of the strength in the January data released may have been due to seasonal effects and warmer weather, which are at risk of reversing in the months ahead. Credit spreads were resilient despite the volatility in rates markets observed, managing to hold onto the majority of gains since the rally commenced in October. For example US investment grade spreads were only 3 bps wider on the month whilst the EUR equivalent was 4 bps tighter. Support herein came from the continued re-rating of global growth expectations given upside surprises in high frequency growth, and as China's re-opening takes full effect. This has reduced fears around a deep recession that would drive a rise in default rates and which now appears less likely. In addition, the earnings



season just passed was not as bad as some investors had been fearing. For example the US earnings season was overall decent with around 70% of companies beating EPS expectations. However we would note that the average size of the earnings surprise was below 1% (vs a 3% beat on average historically) despite weakened expectations going into this season. Revenues were up 6% YoY in nominal terms while EPS were down 3% YoY on average underscoring some margin erosion but from a high base. The financial sector meanwhile continued to exhibit robust earnings and is a sector we believe can benefit from this higher rates and inflation backdrop. As a result, we maintain our positive bias towards credit markets, viewing all-in yields as attractive and elevated enough to provide a buffer even if there are bouts of spread wide.

- March exhibited significant volatility across risk and interest rate markets as investors digested the banking stress described above. Given uncertainty with regards to contagion risks from these events, credit spreads widened with the financial sector underperforming. For example US investment grade credit spreads widened by 20 bps during the month and the European equivalent by 21 bps as expectations for domestic growth outlooks were also put into question on the back of the likely tightening in credit conditions that is set to follow. That said, we did see spreads recover in the 2nd half of the month after the Fed announced emergency liquidity facilities to shore up the banking system, whilst the Fed meeting also received a dovish reaction. Whilst the Fed still hiked rates by 25 bps, the updated dot plot projections showed an unchanged 2023 median dot of 5.1% which suggests that Fed participants are only pencilling in one more rate hike in the cycle. Furthermore, the language in the statement saw significant changes and hinted that the tightening cycle may have already ended as the committee is now anticipating “that some additional policy firming may be appropriate”, which is in contrast to the prior statement which said that “ongoing increases” would be appropriate. Importantly, the Fed also acknowledged recent banking sector stress by viewing it as likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring and inflation. Although the ECB provided a larger 50bp hike, President Lagarde also provided a more cautious tone in her press conference relative to previous meetings, whilst the ECB statement also recognised current market tensions and emphasised the importance of their data-dependent approach to policy decisions. In light of the banking stress, we saw demand for safe haven assets soar, including US and European government bonds, which drove a sharp rally in rates markets. US 10 year yields for example declined by 45 bps in March alone in a move that was also supported by a dovish Fed meeting, whilst the equivalent German yield declined by 36 bps during the month. Developments herein also resulted in a re-assessment of terminal rate expectations which fell by 53 bps in the US and 43 bps in Europe and which also allowed for curves to steepen. Market moves this past month have highlighted the benefit of holding interest rate duration in portfolios, which has provided protection against the credit spread widening observed, and we maintain our positive bias here in the US in particular. This is especially the case at a time when the Fed appears to be approaching the end of its tightening cycle and as we now await for the hikes delivered to feed through to the economy which should allow for the disinflation trend to remain intact. Despite the widening in spreads observed, we maintain our positive bias towards credit markets as well, with policymakers appearing to have dealt with



the near-term stresses in the banking sector. Whilst further volatility cannot be ruled out, we believe that one is being compensated for this through elevated all in yields and with credit fundamentals in check for this stage of the cycle. In addition whilst we do expect to see growth slowing down, we do not expect a deep recession to drive a significant rise in default rates.



Q1 2023

Performance Review

- In Q1, UBP PG Active - Income decreased +1.8% net of fees, (I Share class).
- The Private Debt allocation delivered +1.3% and the Public Debt allocation delivered +3.2% since the beginning of the year.



Portfolio Activity

- At the end of the quarter, the yield of the portfolio in USD was 11.9%.
- The interest rate exposure 0.6 years
- The overall credit allocation was:
 - ▶ Private debt: 59%
 - ▶ Public debt: 41%

- As of 31 March 2023, Partners Group Active Income S.C.A., SICAV-SIF held an active portfolio of investments in 33 companies, broadly diversified across countries and industry sectors. No transactions were made in the first quarter of 2023.



Q1 2023

Outlook

- We are mindful of the pressure that borrowers are under due to rising interest costs paired with an uncertain macro-outlook. We remain focused on investing in noncyclical, defensive businesses with the ability to sustain higher capital costs and absorb or pass-through inflationary pressures. Given the correction in debt markets, we believe there are strong investment opportunities in Private Debt: Due to fluctuating market conditions, banks were not willing to take on new business or provide credit on suitable terms, creating demand for funds to deploy capital. This allows quality loans with solid documentation to be acquired now at deep discounts. Furthermore, we are able to make add-on investments on existing portfolio companies. These are longer term opportunities that enables us to increase our investment in performing credits. Moreover, new LBOs offer high-quality loans that enable us to conduct thorough due diligence and create lender-friendly structures and terms. Finally, higher global interest rates, attractive portfolio valuation and favourable credit conditions have resulted in the highest gross yield in ten years, reflecting the current attractiveness of Private Debt and offer a unique opportunity for investors.

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