UBP PG - ACTIVE INCOME

Quarterly Comment

For Professional Investors in Switzerland or Professional Investors as defined by the relevant laws.

Market Comment

- Looking at private markets, during the quarter, the loan demand in the US was exceptionally strong on the back of increased risk-on sentiment of investors and positive COVID-19 vaccination news. For Q4 2020, loan issuance was USD 80.5 billion, the highest level since Q1 and a 9% increase from Q3 levels. Issuance volumes in Q4 were largely driven by buyouts and acquisitions, as buyers made up for lost time and sponsors tapped billions of dry powder. In Europe, institutional loan issuance slid 25% in 2020 to EUR 51.7 billion, from EUR 69.5 billion posted in 2019. This marked the fourth consecutive year of issuance declines for the Euro institutional loan market, despite a strong bid for loan paper from CLOs.
- Following a stunning loan trading price recovery in Q2 and Q3, wider new-issue loan spreads continued to be the main attraction for investors in Q4, with the average institutional loan spreads topping 504 bps (comprised of 410 bps coupon, 37bps of accreted Original Issue Discount (OID), and 57 bps of average Libor Floor). Even with strong investor demand, average loan spreads in Q4 remained wider due to the prevalence of B-/B3 rated issuers and the risk premium demanded.
- In Europe, a notable decline in new loan issuance in the second half of the year against a backdrop of surging loan investment demand, led to the average yield to maturity of single-B rated issuers dropping to 4.39% in Q4, down 0.35% from the previous quarter. However, while the spreads of new issue loans have recovered, the terms offered are still attractive due to lower leverage levels of portfolio companies, more covenants in the credit documentation and increased use of interest rate floors.
- Turning to public markets, the loss of momentum in risk markets continued for a second month in October as investors prepared for the upcoming US election and as Covid-19 concerns resurfaced. In particular, the pandemic infection rate accelerated in the UK and several core European countries including France and Germany, triggering the announcement of nationwide lockdown measures being brought in for at least the month of November. This resulted in growth expectations being revised lower in the region for Q4, with the risk of a double dip in growth becoming a clear possibility, which also drove policymakers back into action. For example in the UK, the furlough scheme was extended to December, whilst in Europe, ECB President Lagarde at the November meeting press conference pre-committed to further easing in December.
- Although investors were already anticipating for an expansion of the PEPP program to come at the final meeting of the year, hopes for a wider package of easing measures rose after the statement mentioned that on the basis of the updated economic assessment, the Governing Council will recalibrate its instruments as appropriate, to respond to the unfolding situation, to ensure that financing conditions remain favourable and to counteract the negative impact of the pandemic on the projected inflation path.

- As a result, we saw a significant outperformance of EUR vs USD rates in October, with German 10y Bund yields rallying by 11 bps, whilst the equivalent US Treasury yields sold off by 19 bps. This underperformance of US rates was not only due to ECB guidance, but also ahead of the US elections in which stable polling left a Democratic sweep as the most likely outcome, which would pave the way for a major fiscal package to be passed early next year. These developments also allowed for US investment grade credit to outperform its European counterpart, with spreads tightening by 9 bps compared to Europe where they only managed to tighten by 2 bps.
- November was a strong month for risk markets following positive news from the eagerly awaited Phase III vaccine trials, boosting hopes that economies will be able to begin normalising in early-2021. In particular, efficacy rates for two of the major vaccine candidates was over 90% which was higher than initially expected, paving the way for potential regulatory approval before year-end.
- Although Covid-19 cases continued to rise in the US in November, and lockdown restrictions were still weighing on the key European economies, the market chose to instead focus on the more medium term benefits of a vaccine, allowing for near-term dips in growth to be viewed as more temporary in nature.
- This is in contrast to the central banks, where both Fed Governor Powell and ECB President Lagarde chose to highlight the more immediate downside risks to growth from the pandemic, thus confirming that monetary policy accommodation would continue. This was especially the case with the ECB, where President Lagarde at the November conference hinted at another easing package to come in December given on going uncertainty related to Covid-19 and with inflationary pressures still lacking.
- Such a move allowed for peripheral spreads to continue to perform, with 10 year BTP spreads for example tightening by 18 bps during the month. This environment described also allowed for European Investment Grade credit spreads to end November 22 bps tighter, whilst US spreads were 21 bps tighter.
- Moves herein were also supported by the passing of the US Presidential elections, in which Joe Biden defeated Donald Trump to become the next President. The result showed a split Congress where the Republicans managed to retain control of the Senate, disappointing those who had expected a Democratic sweep. This also allowed for the US rates curve to bull flatten in November with the 5s30s curve 6 bps flatter as hopes of a large fiscal stimulus package were tempered as such a policy would struggle to make it passed the Senate.
- The year ended on a strong note for risk markets as investors took confidence from the commencement of the vaccine rollout in the US and UK. Positives also came out of tough negotiations as another Covid-19 fiscal package was approved in the US, whilst the UK and EU finally managed to agree on the terms of a Brexit trade deal ahead of the year-end deadline.
- As such, US Investment Grade Credit spreads managed to tighten another 9 bps in December, whilst European spreads were 2 bps tighter. Moves herein came despite Covid-19 cases appearing to accelerate again and lockdown measures being extended in the Eurozone and UK in particular, in light of the news regarding a more infectious Covid-19 variant beginning to spread. Investors chose to however focus on the more medium term positives of the vaccine rollout, which coupled with the US fiscal package which provided another round of stimulus cheques for individuals, has appeared to improve hopes that the growth recovery will continue in 2021.

- Central banks also played their part in assisting markets, as they have done since the Covid-19 crisis began, as both the Fed and ECB maintained accommodative policies in the final meeting of the year. The Fed for example released its updated dot plot in which they estimate for interest rates to remain unchanged at the zero lower bound over the forecast horizon, whilst the inflation rate is only expected to get back to target in 2023, suggesting no urgency to turn policy restrictive. At the ECB, the Governing Council delivered further easing, increasing the envelope of the pandemic emergency purchase programme (PEPP) by EUR 500bn, as well as extending such purchases until at least March 2022, in a bid to preserve the favourable financing conditions over the pandemic period.

Performance Review

- UBP PG Active - Income increase 3.9% net of fees, (I Share class).

  Before fees, the Private Debt allocation delivered 3.4% and the Public debt allocation delivered 6.6%.

Portfolio Activity

- At the end of the quarter, the yield of the portfolio in USD was 5.4%.
- The interest rate exposure 0.3 years
- The overall credit allocation was:
  - Public debt: 48%
  - Private debt: 52%

- During the quarter, the interest rate duration of the public debt portfolio was halved from roughly one year to 0.5 years. The high yield exposure ended the quarter at 102% of the public debt component, split 50% US and 52% Europe.
- On the private debt side, as of 31 December 2020, Partners Group Active Income S.C.A., SICAV-SIF held an active portfolio of investments in 42 companies broadly diversified across countries and industry sectors. Portfolio activities during the fourth quarter of 2020 included the realisation its first lien debt investment in Pretium Packaging, a manufacturer of customized rigid plastic packaging solutions, such as plastic containers and closures. Partners Group initially provided debt financing to the company in November 2016. Founded in 1992 and based in the US, Pretium Packaging operates out of 19 plants, selling its products to a diversified customer base and a variety of end markets including food and beverage, healthcare and pharmaceutical, household and industrial as well as sports and personal care.
- Overall, the Program's portfolio recorded a positive performance during the fourth quarter of 2020 as the portfolio recorded steady (cash) interest income and higher mark-to-market valuations of performing loan positions. Worthwhile to mention is that portfolio risks and expected losses are fully reflected in the valuation and the recovery is expected to continue with repayments at par. The floating rate loans with base rate floors are providing a natural hedge against inflation and very limited interest rate risk, providing an attractive positioning for investors in a reflation scenario with the anticipated global economic expansion from the pandemic. The current yield to maturity of 7.1% is offering an attractive risk and return profile given the illiquid part of the loan market has not recovered as much as the broadly syndicated loans markets did.

- Partners Group's global Private Debt investment team remains focused on protecting value across our portfolio while maintaining a stringent underwriting discipline to evaluate idiosyncratic risk and limit the downside risk. In the first half of 2021, Partners Group sees opportunities in large-cap/upper-mid-cap second lien and senior unitranche financings in the mid-cap segment as well as M&A transactions with attractive risk return profiles

Outlook

- Despite accelerating Covid cases into year-end, risk markets concluded 2020 on a strong note as investors took confidence from the commencement of the vaccine rollout in the US and UK. Positively, 2020 also ended with key agreements being made in both the US and Eurozone following tough negotiations, clearing the outlook for the year ahead. In particular, another Covid-19 fiscal package was approved in the US, whilst the UK and EU finally managed to agree on the terms of a Brexit trade deal ahead of the year-end deadline. As we look ahead to 2021, we anticipate that the global growth recovery will remain intact as vaccine distribution will allow economies to gradually normalise, where we see the self-enforced slowdown that is set to come in Q1 due to the reintroduction of lockdown measures as a short-term blip to the recovery, rather than anything more sustained or persistent. In addition, we expect monetary policy will largely remain accommodative, despite most of the major easing announcements having passed, with fiscal policy now set to play a larger role following the Blue Sweep in the US, paving the way for another relief package.
- The dovish stance being taken by central banks was highlighted by the Fed in its final meeting of the year. For example, the updated dot plot shows that the board sees rates unchanged at the zero lower bound over the forecast horizon, whilst the inflation rate is only expected to get back to target in 2023. This is a clear indication that interest rates are unlikely to lift off for the near future, especially given the Fed’s enhanced forward guidance in which it now aims to achieve inflation moderately above 2% for some time, so that inflation averages 2% over time. With the committee now focussed on its average inflation framework, as well as looking to cover what they describe as shortfalls in employment, rather than just deviations, it suggests a more patient Fed than in the past. The Fed will therefore be waiting to see both inflation and labour market pressures build before looking to react with any interest rate tightening. Despite progress on the vaccine front, it was clear from the last press conference that Chair Powell is more concerned about the short-term impact on the economy from the re-acceleration in Covid-19 cases, rather than the medium term benefits of the vaccine rollout.

- The more imminent policy decision in focus for the Fed will be its plans regarding quantitative easing, as expectations are mounting for a tapering announcement to be made during the course of the year as the economy may get to a stage where such loose liquidity conditions are no longer required. Whilst we see this as a possibility, we would not expect this discussion to be brought onto the table until at least the second half of the year given that the economy is still battling with the pandemic, as highlighted with the December payrolls print, which was the first negative reading since April. That said, we are not overly concerned with the weak labour market data as there were still broad based gains observed away from the leisure sector. We also think that the outcome of the recent Georgia Senate runoff has cleared the path for another sizeable pandemic relief bill to be passed once President-elect Biden has been inaugurated, after the Democrats managed to gain a very marginal Blue Sweep outcome from the elections. The bill will likely include another round of stimulus checks for individuals, which will support personal incomes and consumption over the coming months, as was observed following the initial relief package in 2020.
- The ECB ended 2020 with further policy support, which largely came through an increase in the envelope of its pandemic emergency purchase programme (PEPP) by EUR 500bn, as well as extending such purchases until at least March 2022. The ECB said that it made such a decision in a bid to preserve the favourable financing conditions over the pandemic period, which highlights to us that the board is committed to keeping peripheral spreads supported in 2021. Although we do see growth also recovering in the Eurozone in 2021, we do not anticipate for the ECB to make any tightening or tapering like announcements given the lack of inflation in the region, which will take pressure off the board from having to act. In the UK meanwhile, although a Brexit trade deal has now been agreed, the near term outlook remains uncertain given the spread of a more infectious Covid-19 variant, which has led to severe lockdown measures being introduced, at least until mid-February. Whilst the Bank of England already delivered with further easing measures through an increased QE program in Q4, the bank is leaving open the option to cut rates into negative territory were it deemed to be necessary. For now whilst this is not our base case, if there was any slowdown in the pace of vaccination distribution then it may force the bank into further action.

- We believe that the environment described above is one in which there is room for markets to revise higher its growth expectations for the year, driven by both the vaccine rollout as well as more fiscal stimulus from the US. We see a marginal Blue Sweep as a healthy outcome for investors in that it will allow for Biden to push through pro-growth policies such as more government spending and less confrontational plans with China, whilst not having enough support for some of his less market friendly ideas such as large tax hikes and significant regulatory changes. When we look ahead to 2021, we also see fewer risk events for investors to position for compared to last year, which should keep volatility supressed, especially given ongoing intervention from the major central banks who we see as having drawn a line in the sand for credit markets, supporting spreads on moments of significant widening. This reduces some of the tail risks for credit, which should also benefit from the backdrop described above of improving growth, less event risk and supportive government policies, allowing investors to continue to pick up the carry.
- This constructive risk environment should also allow interest rate markets to continue to breathe higher, led by the long-end in a reflation type move given expectations for another large pandemic relief bill out of the US and hopes that the vaccine rollout will allow for the Q1 slowdown to only be a temporary one. Ultimately though, we would expect for the interest rate move to be capped following the initial sell-off as we see any inflationary pressures as temporary in nature, largely driven by supply bottlenecks due to the pandemic, rather than anything more structural. From a longer-term perspective, we think that the pandemic has further fuelled several disinflationary forces that were already in play such as technological change, whilst ongoing labour market slack suggests that it will be some time before we see real demand side pressures come through that would force central banks to tighten policy in a significant or abrupt way.

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