UBP PG - ACTIVE INCOME

Quarterly Comment

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Market Comment

- **Private debt**. This has been an unusual interest rate hiking cycle: structural shifts have lowered interest rate sensitivity and monetary policy is not having the usual effect. Thus, while we have seen global economic resilience until now, we continue to expect a slowdown on an aggregate level. Higher interest rates and macro uncertainty still weigh on investment volumes and entry valuations. We have noticed a recent improvement in lending activity, albeit capital providers remain highly selective. The good news is that any improvement in lending markets will likely trigger the release of investment dry powder, which sits at record highs, and encourage exits. Private debt has been able to cement its place as a proven alternative to more traditional fixed income products during 2023. The asset class has stayed highly attractive from a return perspective due to the floating rate nature of its offering, which meant yields were significantly higher than historic levels. Direct lending continued to gain market share following the retreat from underwriting banks.
- **Public Debt**. July provided further evidence of slowing growth and disinflation among major developed economies. In the US, activity remained robust although some softness was observed by the most recent PMIs with emerging signs of easing service sector momentum. Meanwhile, headline and core inflation along with core PCE all surprised to the downside with forward looking indicators including the moderating employment cost index and producer price growth pointing to further downside pressures on inflation in the coming months. The labour market has softened further as shown by dropping job vacancies, quits and hires, but the labour market remains tight overall. Robust labour market demand coupled with moderating inflation led to an improvement in consumer sentiment in July which, coupled with the ongoing stabilisation of the housing market, suggests postponed risks of a more pronounced economic downturn. In the Euro-zone, the economy lost further momentum this past month. German data disappointed again with PMIs showing an intensified downturn in the manufacturing industry and easing services momentum. As a result, pessimism over the German economic outlook increased among businesses and investors. Eurozone inflation provided encouraging news on the headline front, decelerating by more than expected, while core remained elevated supported by services inflation. We expect inflation to be supported during the summer and ease more meaningfully later this year as weaker loan demand from households and businesses, as shown by the recent ECB bank lending survey for Q3 2023, translates into softer consumption and investment. In China economic data continued to disappoint prompting the announcement of several new targeted measures to boost consumption, support the property market and promote investment. Overall, we expect global inflation and economic growth to soften in the second half of the year but global growth to remain robust in 2023 as a whole.

- With data released from the US suggesting that the soft-landing narrative remains intact, risk markets continued to be supported as a result. US investment grade spreads for example tightened by 9 bps on the month and the European equivalent by 14 bps. The earnings season also kicked off positively where with over two-thirds of the S&P 500 companies having reported, 60% have beaten on revenues and 82% on EPS which is a strong beat to miss ratio. In addition, the average EPS beat is 6% which compares to the historical average of closer to 3%. Support for European credit also came from ECB guidance which is sounding more balanced over time. For example at the July ECB meeting, President Lagarde did not commit to a hike at the September meeting with an emphasis on data dependence, whilst the most hawkish members of the board in the Bundesbank & Dutch Presidents also refrained from providing clear guidance.
- This allowed for European rates to outperform, particularly at the front-end of curves with German 2-year rates for example declining by 16 bps and the US equivalent declining by just 2 bps in July. Whilst Fed Chair Powell at the July Fed meeting also chose not to pre-commit to another rate hike despite it being in their dot plot projections, the market instead chose to focus on the more resilient economic backdrop relative to the Eurozone. Overall we view these recent central bank meetings as confirming that peak hawkishness is behind us, which supports our positive duration bias, particularly at the front-end of curves given the potential for the curve to steepen further, as is typical at the end of hiking cycles. Recent data divergence also suggests that European rates have room to outperform US. For credit we remain positive, particularly on the higher income segments of the market given elevated all-in yields and the resilient growth backdrop which continues to push out any recession fears as has once again been observed with this past month's data releases.
- US economic growth continued to outperform in August, supported by tight labour markets and driving expectations for Q3 growth higher as the month progressed, with the Atlanta Fed's own nowcast for the quarter at an elevated 5.6%. Whilst we did observe some moderation in activity, with the flash PMIs for example surprising to the downside in the US, they still remain in expansion territory for both the manufacturing and service sectors. This is in contrast to what was observed for the Eurozone, with its flash PMIs in contraction for the manufacturing sector for the 14th consecutive month, whilst the service sector moved into contraction for the first time this year. The outlook for Chinese growth is also weighing on the Eurozone, where high frequency indicators continue to highlight an economy that is increasingly at risk of missing its 5% annual growth target. This is also forcing the Chinese authorities to announce further measures to support the economy, and particularly in the property sector in August with cuts to both mortgage rates and downpayments for homes announced. We anticipate for the trends described herein to continue, with the US economy finding support from a tight labour market and elevated wage growth, allowing for a soft landing to occur. The disinflation trend also appears to remain intact as US headline inflation surprised the downside in August, whilst core inflation trends in both the US and Eurozone remain encouraging. For example we see a clear possibility that core PCE could reach the Fed's year-end estimate by the end of Q3.

- Rates curves steepened in August as investors pushed out their expectations for rate cuts in the US amid the resilient growth backdrop, instead following the “higher for longer” interest rate environment being communicated by central banks. US 10-year yields rose by 15 bps in August amid this backdrop, although the 2-year yield declined by 2 bps as the curve twist steepened with expectations for the Fed’s terminal rate were largely unchanged. Fed Chair Powell also chose to not deliver an increasingly hawkish message at the Jackson Hole conference, instead maintaining his communication from the prior press conference which highlights to us that the Fed is close to, if not at the end of its tightening cycle now. European rates outperformed in August with 10-year yields declining by 3 bps given growth underperformance relative to the US and with even the most hawkish members of the board unsure whether a September rate hike is still warranted. We view such developments as supporting our positive duration bias, particularly at the front-end of curves given the potential for the curve to steepen further, as is typical at the end of hiking cycles.
- The move higher in real rates weighed on risk markets during the month with credit spreads also impacted as US investment grade spreads widened by 6 bps in August and the European equivalent by 8 bps. Despite this widening we remain positive on spreads given our soft-landing growth outlook and as we anticipate that peak hawkishness has now passed. From a micro perspective the latest earnings round also indicates that company fundamentals remain in decent shape with all major sectors reporting positive earnings surprises in the US and as forward guidance from companies is finally beginning to improve.
- Central bank meetings were in focus over the past month as both the Fed and ECB committed to a higher for longer communication with regards to the path of monetary policy. This could most clearly be observed at the Fed where although they chose to maintain unchanged policy rates, attention turned to their updated dot plot projections which now signalled just two rate cuts for 2024 relative to the four rate cuts in the prior forecast, whilst one final hike was maintained in the projections for this year. The economic growth revisions were also significant, with GDP growth revised higher to 2.1% from 1% previously for this year, whilst the unemployment rate is now forecast to see no further loosening for the remainder of 2023, unchanged at the current level of 3.8%. Developments herein highlight the recent strength in the US economic data, as confirmed once again by this month’s data releases which included a beat on retail sales as well as upward revisions to the savings rate which suggest that the consumer is still in good shape. Meanwhile at the ECB, the Governing Council decided to unexpectedly hike the deposit rate to 4% given continued inflationary pressures as observed through their updated forecasts in which headline inflation is only expected back to the 2% target in Q3 2025. As a result of these developments, we saw rates move higher in September and particularly at the longer end of curves which led to bear steepening pressures. For example, the US 2-year vs 10 year curve steepened by 29 bps in September alone whilst the German equivalent was 15 bps steeper. The move higher in rates was largely driven by real rates with the tightening in financial conditions herein weighing on risk markets as the month progressed and particularly in the US. For example, US investment grade

spreads ended September 6 bps wider, whilst the European equivalent was in contrast 5 bps tighter, being supported by hopes of a pick-up in growth as hinted at in the stabilization of the latest flash PMIs and on expectations that Chinese stimulus efforts could provide support the outlook.

- With regards to interest rate duration, we continue to believe that we have passed peak hawkishness from the central banks. Even though the ECB hiked the deposit rate to 4%, a new sentence in the statement hinted to us that this could represent the final hike of the cycle as they noted that rates have now reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target. For the US, we do see signs of labour market loosening which we expect to weigh on Fed decisions ahead, as clearly seen with the decline in payroll growth over the past year to 150k in three month moving average terms, which compares to over 300k at the beginning of this year and over 500k at the beginning of 2022. We also believe that the disinflation trend remains intact, which could result in core PCE ending the year below the Fed’s current 3.7% year-end projection.
- That said, we continue to have a steepening bias within our duration view, having a preference for holding interest rate exposure towards the front end of curves which should be anchored, seeing room for curves to dis-invert over time as hiking cycles come to an end. For credit, we continue to view it as an environment which will see an orderly slowdown in growth over time, rather than a reacceleration or severe recession. This backdrop is one in which default rates should remain well contained and suggests holding credit exposure within portfolios. Specifically, we believe that one should be building balanced portfolios, holding both interest rate duration and credit risk, as government bonds should protect portfolios in a growth slowdown environment, where one can also benefit from elevated all-in yields as a result.

Performance Review

- UBP PG Active - Income increased +1.8% in Q1, +2.3% in Q2 and +2.1% in Q3 net of fees, (I Share class). YTD, the fund delivered +6.3%.
- YTD, the Private Debt allocation delivered +6.7% and the Public Debt allocation delivered +8.0%.
- QTD, the Private Debt allocation delivered +2.8% and the Public Debt allocation delivered +1.8%.

Portfolio Activity

- At the end of the quarter, the yield of the portfolio in USD was 11.7%.
- The interest rate exposure 0.8 years
- The overall credit allocation was:
  - Private debt: 56%
  - Public debt: 44%

- As of 30 September 2023, Partners Group Active Income S.C.A., SICAV-SIF held an active portfolio of investments in 29 companies, broadly diversified across countries and industry sectors. Partners Group Active Income S.C.A., SICAV-SIF also continues to see a healthy level of repayments in the portfolio. Companies are opting to pay down subordinated debt tranches to adjust their capital structures in line with current environment. Notable transactions that took place over the period include:
- Froneri - Partners Group realized its mezzanine debt investment in Froneri with a gross IRR of 10.9% and gross TVPI of 1.80x. Based in the UK, Froneri is the second largest ice cream manufacturer in Europe and the third largest worldwide with prominent brands including Haagen Dazs, Nuii, and Oreo. The company was founded through a joint venture between Nestlé and R&R. Following Partners Group's investment in 2017, Froneri focused on further expanding its brand and geographic footprint both organically and via M&A. For instance, the company acquired Nestle's US ice cream business and New Zealand ice cream company Tip Top.
- Zentiva - Partners Group realized its first and second lien debt investment in Zentiva with a gross IRR of 6.9% and gross TVPI of 1.33x. The loan was provided in October 2018 to support Advent International's acquisition of the company. Founded in 2018 and headquartered in Prague, Zentiva is a European developer, manufacturer and marketer of generic pharmaceutical products. The company operates two research and development centers in the Czech Republic and India and manufactures over 50% of its products from four facilities located in the Czech Republic, Romania, and India.

Outlook

- We believe the asset class can continue to outperform, especially in a higher-for-longer interest rates scenario. We see private debt fundamentals remaining relatively strong, with steady EBITDA growth and leverage levels of recent transactions below historical averages. Moreover, macro uncertainty will increasingly direct borrowers to the execution certainty offered by direct lenders. While we notice underwriting activity by banks slowly coming back, this option will likely only be available to the highest-rated borrowers for the time being. Under our base case assumptions, we expect a pick-up in investment volumes in Q4 2023 and H1 2024.

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.

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