UBP PG - ACTIVE INCOME

Quarterly Comment

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Market Comment

- In private markets, after a strong US economic recovery in 2021 following the post-COVID market re-opening, expectations were equally high for the US loan market in 2022. Investors were still flush with cash and issuers were eager to come to market to capture it. However, things did not go as planned. To start, the long-awaited transition from a LIBOR base rate to a term SOFR rate for all new loans issued after 1 January 2022 took center stage. New US leveraged loan issuance for Q1 2022 totaled USD 113.5 billion, lower than any quarter in 2021, but nonetheless a surprisingly strong result considering that activity in February and March was diminished by the Ukraine invasion. Loan demand from new-issue CLOs was notably lower during Q1 but solid retail appetite bridged the gap due to heavy weekly inflows. Retail investors increasingly sought out floating rate assets as the Fed commenced raising rates and loan funds quickly invested USD 22 billion in the US loan market during Q1, the strongest quarter of retail activity in many years. Separately, new-issue CLOs added USD 30 billion of loan investment demand for the quarter, despite a rather challenging issuance environment. As usual, M&A activity was the leading contributor, comprising USD 76 billion, or 67%, of all new loan issuance. This included USD 40.7 billion from private equity-backed LBO transactions; USD 17.6 billion from acquisition finanacing by private equity-backed companies; and a remaining USD 17.6 billion from corporate M&A. Also notable was the drop-off in loan refinancing activity, as both the SOFR transition and the Ukraine headwinds dampened refinancing interest from buyers and issuers alike, and as a result just USD 22 billion was completed in Q1. Lastly, dividend recap activity slowed signficantly, contributing just USD 4.7 billion for the quarter (following the most active dividend recap year ever in 2021).
- As the year opened in 2022, European loan market technicals remained strong thanks to the record pace of activity in 2021 and market expectations for another robust issuance year. January began with heavy new-issue loan volumes, which carried over into February, before the geopolitical headlines from Ukraine overwhelmed and paralyzed investors and issuers alike. New-issue loan activity for the second half of February dipped and by March there was no new loan issuance at all. Secondary loan trading volumes followed suit after peaking in mid-January, as loan bids dried up and prices slumped. European new institutional loan issue volumes totaled EUR 16.4 billion in Q1 2022, compared to EUR 18.8 billion in Q4 2021. While January started well with EUR 11.2 billion of new issuance, February saw the pace of syndicated loan issuance recede by mid-month, and March posted zero syndicated loan issuance, as the Ukraine invasion effectively froze market activity.

- For those loans issued in Q1 2022, EUR 9.8 billion (60%) were M&A related, EUR 4.9 billion (30%) were refinancings, and the remaining EUR 1.6 billion (10%) were from recapitalizations. This all culminated in the slowest first quarter of Euro loan issuance since 2016 and was notably off the pace from a year ago (Q1 2021) when institutional loan issuance volumes topped EUR 36.1 billion.
- In public markets, central banks were in focus in October as ongoing fears around inflation led investors to pull forward their rate hike expectations substantially. This was initially driven by the Bank of England after Governor Bailey signalled that they would have to act in the coming meetings, which resulted in investors anticipating a rate hike as soon as the November meeting. This put pressure on short-end rates across developed markets, with curves seeing significant flattening moves as a result.
- Other G10 central banks added to the hawkish rhetoric as the Bank of Canada brought forward its rate hike guidance from the second half of 2022 to the middle of the year, whilst they also surprisingly decided to end asset purchases. Meanwhile the Reserve Bank of Australia chose not to defend its yield curve target despite the move higher in rates observed, signalling an effective end to its Yield Curve Control policy.
- Turning to fixed income markets, 2022 began on a volatile note as the hawkish shift taken by several key central banks towards the end of last year extended further. One of the main messages delivered by Fed Chair Powell was that this tightening cycle will be different to the gradual hiking cycle that began in 2015, where he chose not to rule out the possibility of a 50bp hike in March or hiking at consecutive meetings in contrast to the general consensus which has been for a gradual, quarterly hiking pace.
- Markets also priced in risks of a more hawkish ECB meeting given rising inflation concerns as energy prices continued their march higher as geopolitical tensions between Russia and Ukraine escalated.
- We therefore saw government bond yields rise sharply in January as the market further re-priced their expectations for central bank tightening with more than five hikes priced for the Fed by the end of this year and two hikes priced for the ECB at the time of writing. Such developments led to US 10-year yields rising by 27 bps in January in a move that was fully driven by real rates, which rose to their highest level since March 2021.
- This real rate move weighed on risk markets, with equities coming under significant pressure on the back of a large sector rotation which saw Growth names weaken aggressively, whilst Value outperformed.
- Credit spreads followed suit with US Investment Grade spreads widening by 13 bps and European spreads were 9 bps wider on the month. Economic data released during the month generally saw a further moderation given the impact of the Omicron Covid wave in December, as observed through the ISM Manufacturing and Services prints which disappointed relative to expectations and also likely weighed on sentiment.

- February was the weakest month for credit market since the Covid-19 outbreak in 2020. The weakness was driven by the Ukraine situation, where the Russian invasion and subsequent severe International, and in particular European, sanctions created uncertainty for the economic outlook.
- European credit markets underperformed, largely due to Europe's dependence on Russian oil and gas exports and the negative effect of Russian sanctions on Europe. EUR Investment Grade bonds widened 41 bps, while US Investment Grade widened a more modest 21 bps. The weakness in European investment grade bonds was exacerbated by the widening of swap spreads in Europe, caused by the high demand but low supply of high-quality liquid assets such as German bunds.
- Similarly, CDS indices (+12 bps iTraxx Main and +8 bps CDX IG) significantly outperformed bonds, reflective of the drop in liquidity conditions which is typical of severe and prolonged market weakness. Against that, USD denominated floating rate notes held up relatively well, as investors continue to look for paper that stands to outperform when the Fed will start raising interest rates.
- The weakness observed in February that was driven by the Russian invasion of Ukraine partially reversed in March as the initial sanction package news had been digested and as it became clear that Europe would not go as far as sanctioning Russian gas imports in the near term.
- As the month progressed, we also saw Russian and Ukrainian diplomats take part in discussions in a bid to find a ceasefire agreement, with talks still ongoing. European Investment grade spread tightened by 14 bps, while iTraxx Main spreads tightened 6 bps as the CDS-bond basis came of the lows following improved market sentiment, liquidity and lower volatility levels.
- In comparison, US Investment grade spreads lagged European spreads, ending the month 1 bp wider as a large amount of new supply (+233 bn) hit the market leading to the fourth largest monthly volume ever. Interest rates continued their path higher, with 5y US rates increasing by 74 bps to 2.46% and 5y Germany rates by 54 bps to 0.38%, while curves continued to flatten.

Performance Review

- UBP PG Active - Income decreased -2.2% net of fees, (I Share class) since the beginning of the year.
- Before fees, the Private Debt allocation delivered -1.7% and the Public Debt allocation delivered -2.3% since the beginning of the year.

Portfolio Activity

- At the end of the quarter, the yield of the portfolio in USD was 6.5%.
- The interest rate exposure 0.4 years
- The overall credit allocation was:
  - Private debt: 56%
  - Public debt: 44%

- The Fund does not have any direct exposure to Russia and Ukraine and only a very limited number of portfolio companies have small revenue exposures typically in sanctioned-exempt sectors, such as pharmaceuticals. In aggregate, less than 1% of total revenues of active portfolio companies is exposed to Russia and Ukraine.
- As of 31 March 2022, Partners Group Active Income S.C.A., SICAV-SIF held an active portfolio of investments in 36 companies broadly diversified across countries and industry sectors. Notable transactions that took place in the Partners Group Active Income S.C.A., SICAV-SIF portfolio over the period include:
- In February, Partners Group provided unitranche debt financing to Biosynth Carbosynth (Biosynth) to support private equity group KKR's acquisition of the company. Biosynth is an integrated organic compound manufacturer and distributor servicing lab diagnostics, life science and pharmaceutical industries. Headquartered in Switzerland, the company has over 200 employees across six facilities in the US, Europe, and Asia. Partners Group finds the company attractive due to its leading position serving a range of niche markets supported by positive underlying structural trends. For instance, Biosynth captures a significant share of the pathogen detection and protein purification markets that have grown consistently over the last five years and are expected to continue growing at a similar rate. Furthermore, Biosynth has a track record of building long-term relationships with its customers, thanks to consistent production of critical high-quality compounds used by customers to manufacture their end-products.
- In April 2022, Partners Group provided unitranche debt financing to The Princeton Review to support private equity firm Primavera Capital Group's acquisition of the company. As part of this transaction, Partners Group also made a common equity investment in Princeton in March 2022. Founded in 1981, The Princeton Review is a US-based test preparation, academic tutoring, and college admission services provider. Furthermore, the company also provides academic tutoring services to businesses through the Tutor.com brand. The Princeton Review has more than 3'800 active instructors and offices in 17 countries.

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.

Outlook

- In private markets, fhe first quarter of 2022 saw a number of economic and political risks emerging that are making the near-term outlook exceptionally challenging. Russia invaded the Ukraine and in response, Western nations announced severe sanctions on Russian exports and financial institutions, including Russia's central bank. Partners Group has limited direct exposure to Russia and Ukraine, but we do believe that second and third order repercussions will impact global growth and inflation. Already before the war erupted, inflation surged to multi-decade highs in many advanced world nations. Energy insecurity as a result of the Russian conflict is further exacerbating inflationary pressures and real incomes and private demand will be affected. In China, millions of people have been put into lockdown and domestic trade is massively disrupter as the government aims to starve off the Covid outbreak.
- At the same time as economic headwinds picked up, inflation expectations rallied. With inflation in the high single digits in the US and parts of the Eurozone, the US Federal Reserve embarked on a monetary tightening cycle and interest rates rose sharply. Capital markets started pricing in a rapid pace of rate hikes for 2022 and 2023 – especially in the US - and equity markets and fixed income came under pressure.
- In our economic base case, we anticipate a notable economic slowdown over the near term, with risks tilted to the downside. We believe consensus has not fully reflected this easing in growth rates, especially in the Eurozone. We also think that consensus underestimates the stickiness of inflation beyond the summer of 2022 as inflationary pressures are broadening, especially in the US. We expect inflation to remain in the 4-7% y/y range for the remainder of 2022 and into 2023. Thereafter, we maintain our view of average annual inflation rates in the 3-4% range in the US and 2-2.5% in the Eurozone. Nearshoring - further amplified by the conflict with Russia and China decoupling – and the energy transition will add to inflation. Consumers and businesses will reflect elevated inflation expectations in wage negotiations and pricing policies.
- In such an environment, Private Debt investments provide the stability that many investors are looking for in in order to protect against the downside in combination with floating rate instruments that do benefit from increasing rates.

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