Market

The themes that have dominated markets over the last 2018 quarters are:

- slowing Economic growth,
- US-China trade war,
- Brexit,
- unclear Fed interest rate policy in the near future,
- Italian fiscal budget,
- end of CSPP.

The above topics contributed to an increasing negative market sentiment, which affected almost all asset classes. These macro factors exposed the €HY to high volatility and negative returns.

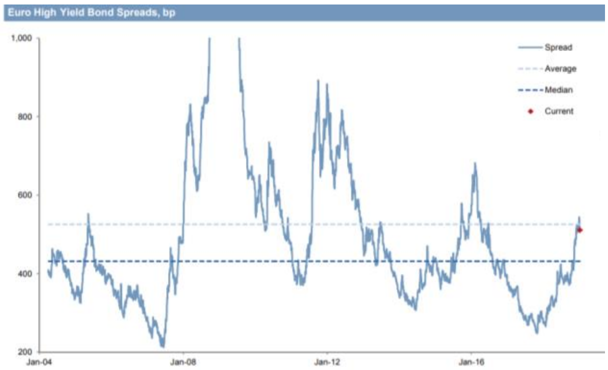

FIG 1 - Source: JPM – average ICE BofAML Euro High Yield Index.

As of today **HY average spreads widened over 500 bps**, the highest level since February 2016, **but they seem fairly priced for several reasons:**

A. **from a macro perspective**, even if most of the main issues mentioned above will remain hot topics for the current year suggesting volatility will persist in 2019, **the market shows some mitigating factors such as**:

   - dovish signals by FED and ECB. While ECB is postponing first hike in 2020, Powell's words signalled a softer monetary policy: indeed i.e. the 10 Y treasury yield went from 3.25% to 2.60%.
   - acceleration in wage growth;
   - some softening in US-China trade war rhetoric;
   - unemployment now at 8.1%, the lowest level since 2008 showed in Fig 2, mainly driven from core EU countries.

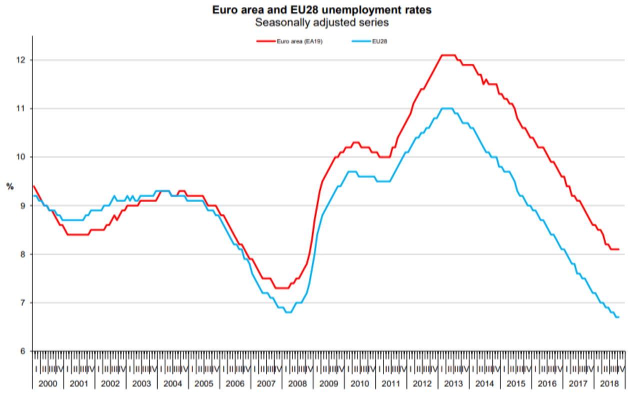

FIG 2 - Source: Eurostat – Unemployment rate

B. **from a technical perspective:**

   - the market seems to have already discounted the main negative themes mentioned above;
   - default rates are foreseen to remain below 2%;

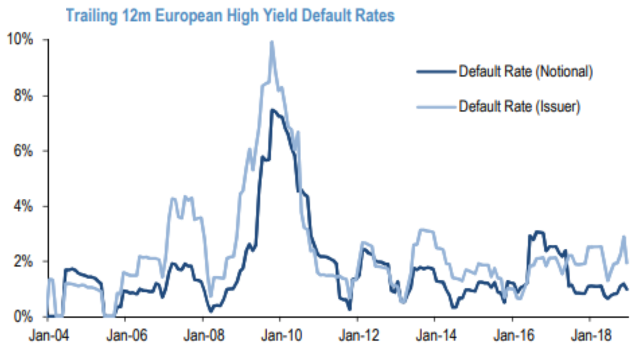

FIG 3 - Source: JPM – Trailing 12 months € HY default rates

   - the QE refinancing environment has allowed companies to bear lower coupon and to extend debt maturities (maturity wall is now heading well into 2023 and beyond);
   - while corporates' leverage ratio have increased, interest cover has peaked, and is holding steady at just over 6x on aggregate.

C. **from demand & supply perspective.** Market dynamics are favorable to fixed income asset class:

   - the sell-off in secondary has created high dispersion and therefore buying opportunities which can be caught throughout a selective approach;

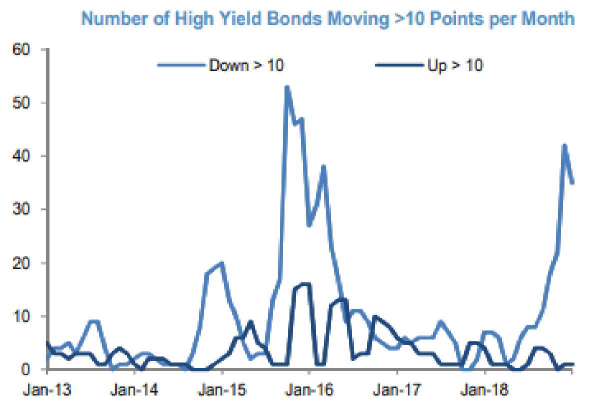

FIG 4 - Source: J.P. Morgan. Rolling three month total of rated euro and sterling HY bonds.

- the ‘normal’ relationship between the €HY and $HY asset class upturned. In fact, the €HY has historically presented tighter spreads because of its higher quality (i.e. €HY market is compared by 70% BB rated assets and US HY only by 45%). Instead, as of today, the European HY is pricing 46bps cheaper than US HY, representing for many foreign investors a better risk - yield opportunity.

FIG 5 - Source: Bloomberg Barclays Pan European HY average spread (blue line); Bloomberg Barclays US Corporate HY average spread (violet line);

Investment Tactics

For the first few months of 2019 we envisage the following features for our EU HY portfolios:

- duration less than 3;
- overweight Non Cyclicals
  - TMT, utilities, pharma and food;
- underweight Cyclicals
  - Auto and industrial;
- opportunistic trades on AT1 and CoCos asset class;
- Opportunistic approach on CDS for those names where we have strong fundamental conviction.