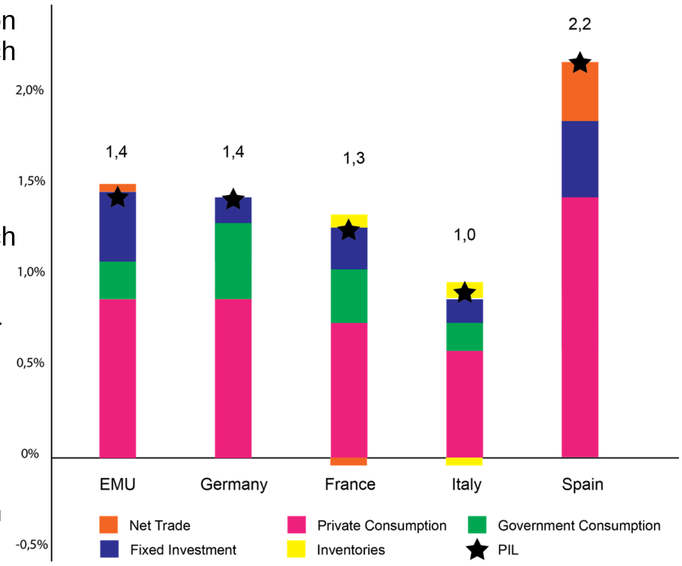
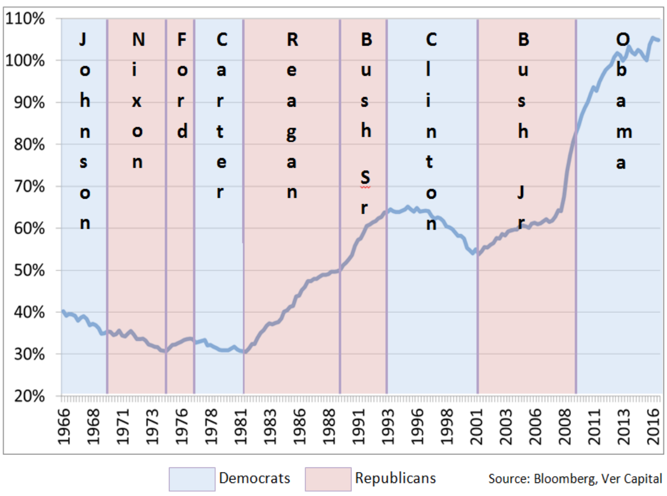
2016 Review

In terms of growth, 2016 can be considered a transition year: less negative for the emerging economies, which have benefited from the rebound in commodity prices, but less good for the developed economies compared to 2015.

The excessive slowness of growth and inflation has convinced the ECB to change its monetary policy, which provided for the end of the CSPP program (Corporate Sector Purchase Program) in March 2017, extending the bond buying program until the end of the year, however reducing purchases from ú 80 bn to ú 60 bn after Q1 2017. the Eurozone grew moderately and unevenly in terms of GDP: Italy has failed expectations, Spain has overcome them, France and Germany have met them. The consensus for 2017 regarding the growth seems to reflect the trend of the year that has just finished as shown by the graph on the right.



United States Public Debt as % of GDP



The US economy grew by 1.5% in 2016 versus a 3.2% in 2015; This decline was largely due to a slowdown in domestic demand and the beginning of the QE restriction. President Trump intends to implement a reform of the taxation system, which could increase the US public debt. It seems that markets believe that Trump can implement a tax cut of $ 5.3 trillion spread over 10 years and infrastructure spending of at least $ 500 billion. Many see the points of contact with what will be the Trumponomics with what was once the Reaganomics, however, Trump will receive the legacy of Obama, with a particularly high debt due to post 2008 crisis maneuvers and the Obama-Care. As a result, as you can guess from the graph, the new president will not have the same leeway that R. Reagan has had in the '80s.

Inflation and Interest Rates ï Outlook 2017

In a survey conducted by Bank of America, 84% of fund managers expect higher inflation globally in 2017. According to The Financial Times, United Kingdom and the United States are the most likely candidates to have a growth of inflation, while for other countries the outlook remains uncertain.

A faster GDP growth and inflation should convince the Fed to raise rates in 2017, albeit cautiously. According to research by Goldman Sachs, at the moment, the markets are discounting by the end of 2017 an interest rate of about 1.2%, or 54 basis points more than the current level. Estimates of the Goldman Sachs analysts forecast that the Fed will raise rates for three times during 2017 surpassing the current expectations of the market.

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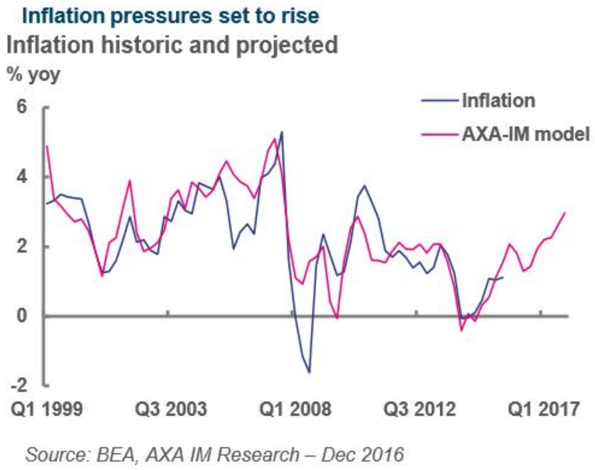


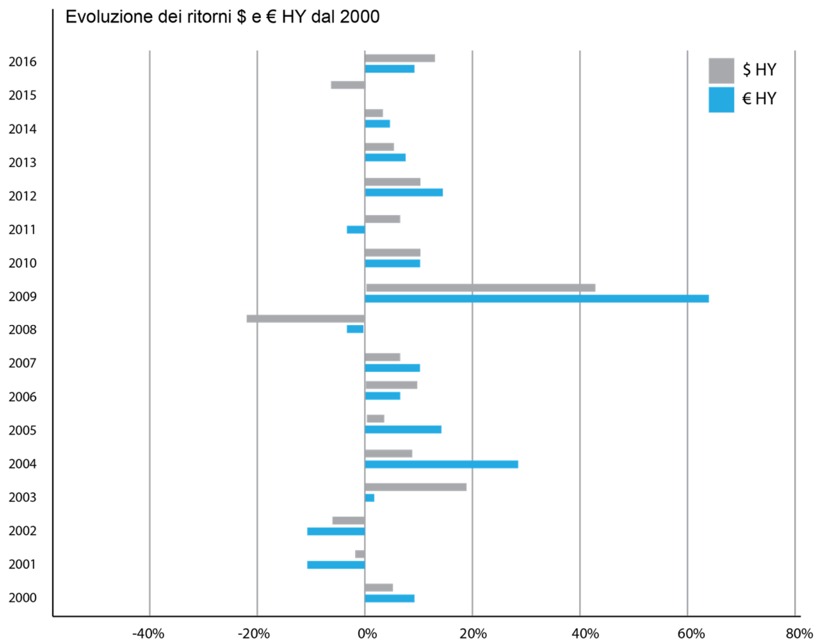
The ECB is conducting a monetary policy based on 3 pillars:

- Interest rates below zero;
- CSPP: that is, as already stated earlier, a QE of ú 80 billion per month until March '17, and ú 60 billion per month until the end of the year;
- TILTROs, or a series of long-term operations with the aim of pushing banks to make more loans (according to some analysts, this tool will gain more power to act once the CSPP runs out of steam).

Despite Draghi has hinted that there might be a possibility for the expansion of the QE, political and practical constraints make this scenario less likely.

High Yield Market

After a non-thrilling performance of the market High Yield (HY) in 2015, 2016 proved to be more favorable, as can be seen from the graph opposite. The underperformance of European HY compared to US in the year just ended was due in large part to the oil prices rebound to which $ HY is more exposed. In any case, it is worth noting that the recovery of $ HY market in 2016 was not enough to offset the losses and underperformance in previous years compared to the excellent performance of the ú HY market.



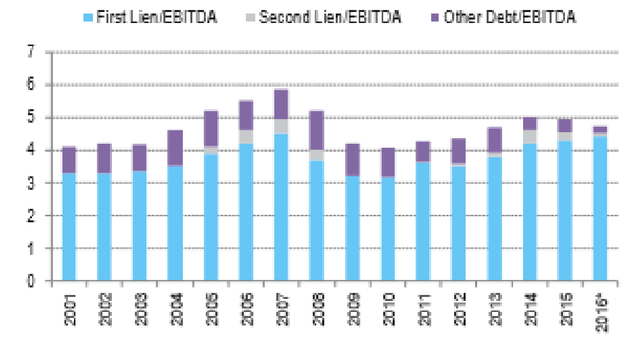
Overall 2016 has been for the ú HY market a dichotomous year, with a second half that performed much better than the first. Furthermore, it showed the resilience of the ú HY market to political shocks as Brexit, American elections and Italian Referendum. The second half of 2016 also coincided with a strong recovery in the HY issuance, which nevertheless remained lower than 2015. It is worth noting that the "scarcity" of the offer resulted, from a technical point of view, in a further prices support, in a context of still low interest rates.

The CSPP program began last June and had an indirect positive effect on the HY segment. In particular, BB emissions were the most hunted, because of their proximity to 'Investment Grade, and recorded a better performance than single B (the narrowing on average was 40 bps for BB against 5 bps for B). Also for this reason, for 2017 analysts show a positive consensus with respect to the single B class. In this context, the European HY issuers have benefited from the favorable financing condition created by the still accommodative monetary policy, refinancing their debt, extending the maturity and reducing the average cost of debt at the same time.

In 2017 a general increase in interest rates and a steepening of the yield curve is expected. According to most analysts, this will put pressure on debt securities (especially safe-heaven and, more in general, government and investment grade bonds) while risky securities, such as HY, could show better resilience thanks to their lower duration and to the fact of being more closely related to credit risk than rate risk, especially in a context of still low default rates.

The graph opposite shows the data collected by S&P representing the average leverage for both loans and HY primary deal over time. Since 2010 the total leverage has always increased until 2014 where it reached 5.0x and then declined to 4.7x in 2016. The first-lien leverage (i.e. considering only the senior secured debt, in which Ver Capital HY Funds typically invest) stabilized in 2016 to 4.5x.

Reported leverage on primary deals (loans and HY)



Sources: S&P, Natixis * in the first 4 months of the year

The default rates associated with the global HY market have had an upward trend from 2015 until the summer of 2016, mainly driven by the $ HY market, which is more exposed to the energy sector and higher borrowing levels by issuers. The Moody's projections show a generalized decrease in the default rate. For $ HY market the rating agency expects 1.8 bps lower than the current rate, standing at 3.8% at the end of 2017, due to the increase in oil prices and subsequent pressure easing on energy and mining, while for ú HY market the rate is expected to fall from 2.1% to 2.0%, thanks to the solid fundamentals of the European issuers.

Political Risk

2017 political agenda is already full of events that could affect the markets.

On January 17, the British Prime Minister T. May has confirmed the UK's exit mode from the EU with the words "Brexit means Brexit". The English economy will depend on the outcome of international agreements between May and Europe. According to research by Natixis, the UK will bear the Brexit effect during 2017, while the Bank of England will continue to assist the British economy while keeping unchanged its monetary policy. Given current conditions, the consensus expects a slowdown in growth of 1.1%, after the 2% recorded in 2016.

2017 will also be a key year for the euro, which will also see the elections in France, Germany, and a still very uncertain political situation in Italy.

Last but not least, there are great expectations around the first indications that will be provided by the ECB concerning the next moves after the end of the purchase program; the first indications being expected starting from the third quarter of the year.

Conclusions:

- According to analysts from the leading investment banks, 2017 will be characterized by a moderately positive global growth and a return of inflation (the latter to a greater extent in the US and UK, and to a lesser extent in the EU and Japan);

- From a macro and political point of view, in the US the focus will be on the reforms promised by the new President, while Europe will have to deal with general elections in France and Germany, with the outcome of preliminary Brexit negotiations and with the first ECB statements relating to the post-QE, expected in the second half of the year;

- The European HY market posted one of the best performances in Europe in 2016. According to many analysts in 2017, in which a general increase in rates and a steepening of the yield curve is expected, the HY segment, although it would not be immune to a rise in market volatility, may show greater resilience than IG and Govies, thanks to a lower duration. In terms of fundamentals, European issuers remain solid and leading rating agencies provide stable or decreasing default rates for 2017.

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