Monthly Fund Commentary

Muzinich & Co

Institutional: MZFIX

December 2018

Fund

Muzinich High Income Floating Rate Fund

Portfolio Commentary

Risk assets experienced significant declines this December on Federal Reserve (Fed) tightening, political uncertainty and weaker economic data. It is worth noting that while US high yield (BofA ML US HY Cash Pay Constrained – JUC0)[1] and loans (Credit Suisse Institutional Leveraged Loan Index)[2] posted their worst monthly returns of the year, equities (S&P 500)[3] declined 4 times as much for the month, dropping more than 9%. In this risk-off environment, fixed income performed as expected with Treasuries attracting assets (and rallying in price) in a flight to quality and outperforming all other segments of the bond market. While the Federal Reserve had clearly telegraphed that it would raise rates at the December meeting, an equity market swoon in early December and public remarks from President Trump pressing the Fed not to raise rates gave some investors the (false) impression the Fed might pause. While the Fed did raise rates in December, markets (as per Bloomberg data) are now forecasting a 0% probability that the Fed raises rates in March. Political uncertainty in the US (border wall, government shutdown, trade tensions with China) as well as abroad (Brexit and Italy) also pushed investors out of risk assets. Finally, weaker economic data has some investors questioning whether an economic slowdown will turn into a recession. While it is difficult to forecast a recession, we believe valuations have certainly become more attractive as investors question economic strength. Whether valuations become even more attractive, stabilize, or tighten depends largely on whether the markets see some resolutions to political issues, Federal Reserve direction, and the strength of the economy.

Strategy and Outlook

Despite holding up relatively well versus other asset classes in the first three quarters of the year, the loan market finally capitulated in December. In an environment of a sharply weakening US loan market[2] caused by large retail outflows, continued weakness in high yield, and anxious times in the equity markets on global growth concerns, loans[2] suffered the largest monthly draw down since September 2011. Despite that disappointing headline return for the index, the market decline was orderly with trading desks reporting good volume well into the middle of the December. Even with weakening market conditions, collateralized loan obligation (CLO) managers were able to price some new deals in December, helping the market reach a record of annual issuance. The primary market was very slow in December. Wrapping up those syndications launched in November proved difficult for some deals, but although timelines were extended, the vast majority of transactions cleared as arrangers elected to flex terms in favour of buyers on more difficult credits to get books covered. We did not participate in the primary market in December.

Here is a trivia question to start the New Year. In how many years since 1994 was the US high yield market down absent a default wave? Answer: none, until now. 2018 was an anomaly in that the US high yield market[1] posted a negative return but the default rate remained exceptionally low at 1.75% for high yield and 1.66% for loans (both par weighted and including distressed exchanges) [Source: JP Morgan, *Credit Strategy Weekly Update*, 14 December 2018]. We believe 2018's challenges were driven by global central bank tightening (the European Central Bank and the Federal Reserve), geopolitical uncertainty and concerns about economic growth. So what about 2019? Our loan outlook remains steady from November, namely, we expect returns to continue to be supported by coupons earned and a buyer base which is dominated by long term institutional investors. Given the weak end to 2018 in terms of investment returns, the new issue market may have a slow start in January 2019 but the pipeline is building again for launches in the near term of add-on transactions to existing deals as well as new acquisition financing mandates. Private equity, whose activity drives the majority of loan new issuance volume, still has significant dry powder to deploy globally according to market estimates, which we believe will be supportive for continued loan market growth, albeit at a slower rate than we saw in 2018.

All references to market performance are sourced from Bloomberg. [1]Source: ICE BofA ML US Cash Pay High Yield Constrained Index (JUC0) contains all securities in The ICE BofA ML US Cash Pay High Yield Index (J0A0) but caps issuer exposure at 2%. As of 12/31/2018. [2]Source: Credit Suisse Institutional Leveraged Loan Index – The CS Institutional Leveraged Loan Index is a subset of the CS Leveraged Loan Index, which is designed to more closely reflect the investment criteria of institutional investors by sampling a lower volatility component of the market. The index exclude facilities that are TL or TL A type, priced 90 or lower at the beginning of each measurement period and rated CC, C or Default. As of 12/31/2018. [3]S&P 500 - The Standard & Poor's 500 Index (S&P 500) is an index of 500 stocks seen as a leading indicator of U.S. equities and a reflection of the performance of the large cap universe, made up of companies selected by economists. As of 12/31/2018.

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