PPM AMERICA

# 2019 Asset Class Outlooks

## VALUATIONS BEING RESET

We consider 2018 to have been a year of transition for US markets. The Federal Reserve was at the heart of the long-term transition. Quantitative tightening ramped higher throughout the year. While the Fed raised rates each quarter, toward the end of 2018 investors looked ahead to 2019 and seemed to struggle with expectations for monetary policy and asset prices.

The Trump administration, meanwhile, was instrumental in the short-term aspects of the market's transition. Asset classes led by equities enjoyed positive performance through the third quarter of 2018 on the back of tax reform. But when the president shifted his focus to global trade policy, and participants shifted their focus from faster 2018 economic and corporate earnings growth to a 2019 deceleration, sharp corrections ensued. It is ironic that so many asset classes closed 2018 in negative territory, during a year of healthy economic and earnings growth.

For 2019, expectations are clearly being redefined. We believe underlying fundamentals are positive, while each asset class has its own technical story. But participants are struggling with valuation, as evidenced by recent volatility, specifically the question of what is fair value.

In 2018, our portfolios generally stayed closer to benchmarks given valuation levels while we sought individual equities and credits that could provide outperformance. In 2019, we anticipate using a similar approach in US equities, investment grade credits and the debt side of commercial real estate. Using investment grade as an example, 2018 widening merely returned its spread to the post-crisis average, so we do not currently see a broad opportunity to add risk.[1] While the above also holds true for high yield bonds and loans, these two markets have additional dynamics. Weakness in the fourth quarter of 2018 pushed prices down and yields up to levels that we believe may become attractive to a broader investment base. If technical headwinds subside and fundamentals remain constructive, valuations would look more attractive in these markets.

(1) FactSet. OAS for the Bloomberg Barclays US Corporate Bond Index. 31 December 2018.

## INVESTMENT GRADE

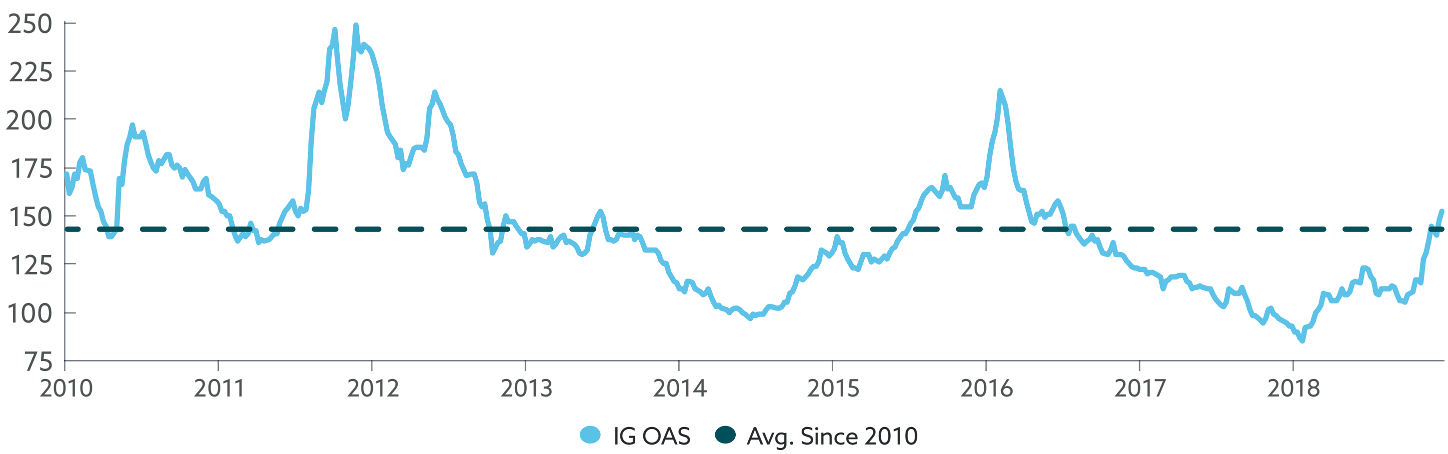
Recent economic releases have pointed to moderating US growth, but levels remain high when compared to global growth. US GDP is expected to grow at 2.5% in 2019.[2] Areas of concern, such as housing, are a small portion of overall GDP. Outside of the US, global growth may receive a tailwind from China, as we expect it to conduct more fiscal stimulus. Moving to US corporate earnings, they will slow down without the initial boost from tax reform, but large caps are still expected to grow around 8%.[3] The one concerning metric for us is the failure of companies to lower leverage amid such strong growth in 2018. Leverage has essentially plateaued at what we consider a high level. However, interest coverage also remains high.[4]

The valuation shift in the fourth quarter of 2018 was the biggest change to the US investment grade market. However, 2018 widening merely returned the index spread to its post-crisis average.[5] As a result, we do not currently see a broad opportunity to add risk, though certain portfolios have added at the margin. Another upcoming catalyst is the heavy primary market calendar in the first quarter of 2019.

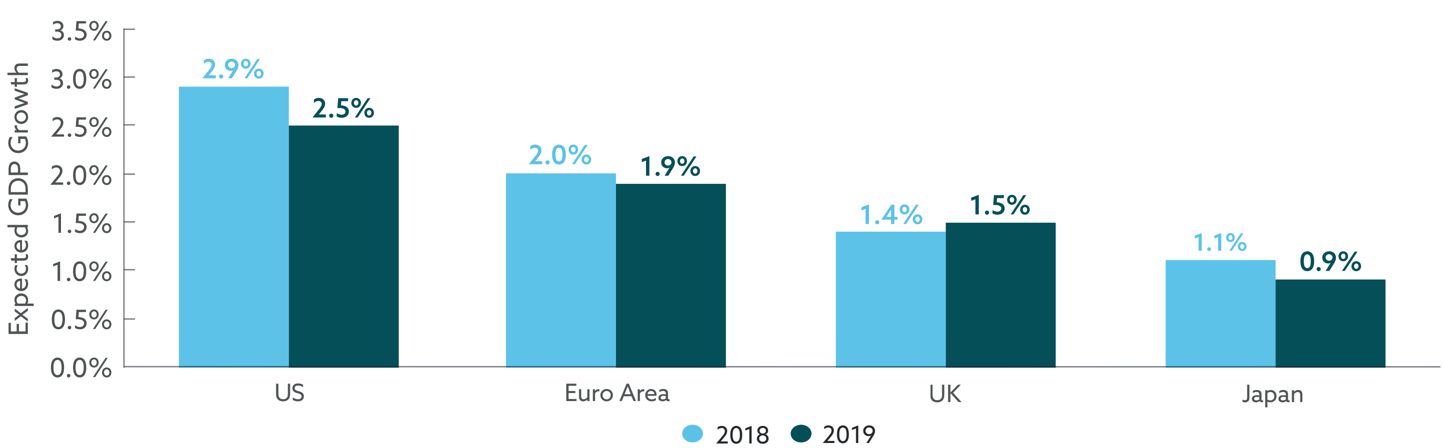
Monetary policy will remain a focus. While we expect inflation to run at or below the Federal Reserve's target, employment data have been at historically tight levels. We expect this to continue, which will likely be enough support for additional hikes. If the Fed were to cease hiking, we believe it would be very supportive of financial assets.

European troubles are a risk to our outlook. Brexit is reaching a precipice, GDP growth has slowed, and Italy and France are dealing with budget uncertainty. The European Central Bank is also a concern. The end of its quantitative easing program means the ECB is no longer a buyer, especially in the corporate credit market. It has also not raised rates or begun tightening the balance sheet, meaning very few tools will be available for the next recession. The BBB segment of the US market is another risk. We continue to view it as an idiosyncratic story, given the relatively healthy US economy underpinning the broader market. There are also two sides to the BBB risk – names will get downgraded and face pricing pressure, but names that are not downgraded can be investment opportunities. Finally, the flattening yield curve is a risk. We have already seen inversion in the front-end of the Treasury curve, which has ramifications for the front-end of the corporate curve. There are portfolio management techniques to employ here, such as shortening maturities where the curve has flattened, but further flattening is a risk.

### RECENT WIDENING HAS ONLY RETURNED IG SPREAD TO POST-CRISIS AVERAGE[5]




### DESPITE DECELERATION, US EXPECTED TO POST RELATIVELY STRONG 2019 GDP[2]




(2) IMF. World Economic Outlook, October 2018. (3) FactSet. 27 December 2018. (4) JP Morgan Research, PPM. Quarterly data as of 30 September 2018. (5) FactSet. OAS for the Bloomberg Barclays US Corporate Bond Index. 31 December 2018.

## HIGH YIELD

The end of 2018 proved to be difficult for most asset classes, and US high yield was no exception. The question we keep asking ourselves is, are we at the end of the cycle? We are not convinced.

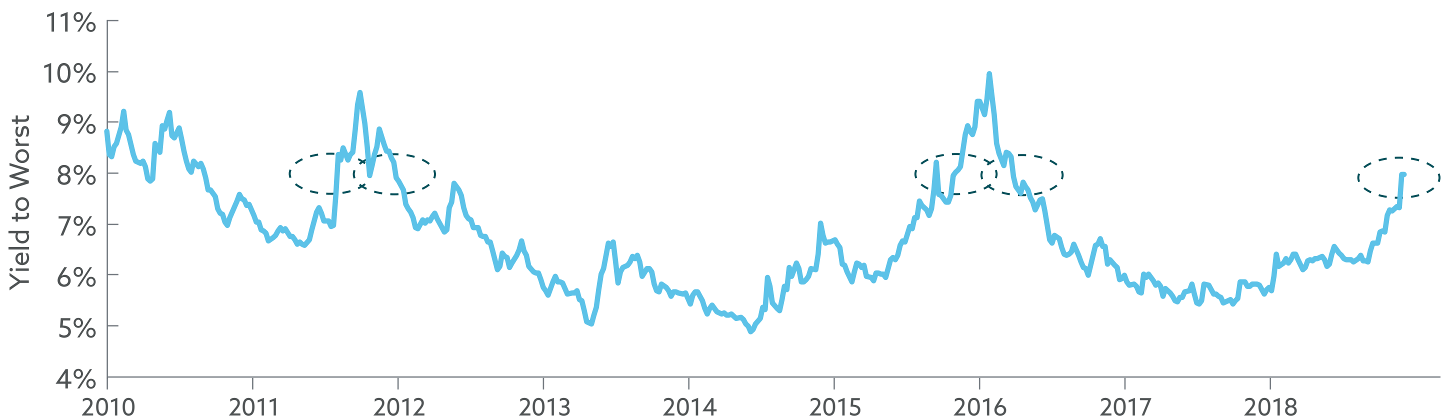
The three choices going into 2019 seem to be: 1) a recession and credits perform poorly; 2) no recession and a significant high yield rebound (perhaps back to the recent high at September-end); and 3) no recession, but decelerating growth and modestly positive high yield performance. We believe the latter is the base case.

The deceleration in the economy and earnings makes sense as the tax reform bump subsides, but growth is still expected and we believe the consumer is in good shape. Speculative grade credits are now yielding around 8%, and we believe there is a yield at which market participants will step in and begin buying, especially as US rates are higher than the rest of the world.[6] Importantly, the high yield market does not have 2008-level imbalances. We do not believe leverage is extended, given the asset class recently exited a mini-cycle around the energy correction of 2015/16 and the high yield bond market has not growth since (all growth has come from the high yield loan market). This is evident in the rise of BB rated credits. Finally, we agree with the consensus that defaults should remain low. They currently are below the long-term average, and the distress ratio is also low.

In terms of high yield market technicals, we expect issuance to remain favorable. The near-term calendar is light, and overall issuance should be down again in 2019. Despite this supply tailwind, the question is what will demand look like. The high yield market experienced significant outflows in 2018, but investors could reverse course given currently elevated yields.[7] High yield is a relatively illiquid asset class, so flows tend to drive, and in some cases exacerbate, market performance.

A focus entering 2019 will be energy, as the sharp correction in crude oil prices has negatively affected the sector. Following the energy cycle of 2015-16, companies generally improved their balance sheets and costs structures came down, providing more flexibility. Similar to the broader high yield market, there is very little talk of defaults in energy following the oil price correction. One item that does need to change is market sentiment. Crude oil prices were trading in the low $50 range a year ago – i.e., not far from current levels – but the result of the sharp correction has been negative sentiment that prices will continue to decline. Our approach to the sector is owning bonds in companies we believe are efficient producers with good assets.

### SPECULATIVE GRADE YIELD AT MULTI-YEAR HIGH[6]




### TODAY'S METRICS STRONGER THAN PREVIOUS PERIODS WITH 8% YIELD[8]

| Date | Yield to Worst | Yield Trending | Coupon | Index Price | Duration | Default Rate | Distress Ratio | BB% | CCC% |
|---|---|---|---|---|---|---|---|---|---|
| 12/24/18 | 8.04% | Up | 6.33% | 91.95 | 4.2 | 1.6% | 6.6% | 51% | 11% |
| 4/13/16 | 8.05% | Down | 6.58% | 91.28 | 4.2 | 5.0% | 19.0% | 51% | 15% |
| 11/20/15 | 8.03% | Up | 6.71% | 91.64 | 4.3 | 2.5% | 20.8% | 49% | 15% |
| 1/3/12 | 7.99% | Down | 8.23% | 98.44 | 4.3 | 2.5% | 15.5% | 48% | 16% |
| 8/8/11 | 8.04% | Up | 8.29% | 98.96 | 4.6 | 1.6% | 15.9% | 47% | 17% |

(6) FactSet. Yield to Worst is the lowest potential yield that can be received on a bond without the issuer defaulting. 31 December 2018.
(7) Morningstar. Based on estimated monthly flows for the US OE High Yield Bond category (including ETFs) through 30 November 2018. (8) FactSet, BofA Merrill Lynch Global Research, PPM. Data are for the ICE BofAML US High Yield Index. Similar to 24 December 2018, the analysis found prior periods where the YTW crossed the 8% threshold and compared market metrics at these times. Coupon, Index Price and Duration data are daily; Default Rate, Distress Ratio, BB % and CCC % are monthly. 27 December 2018.

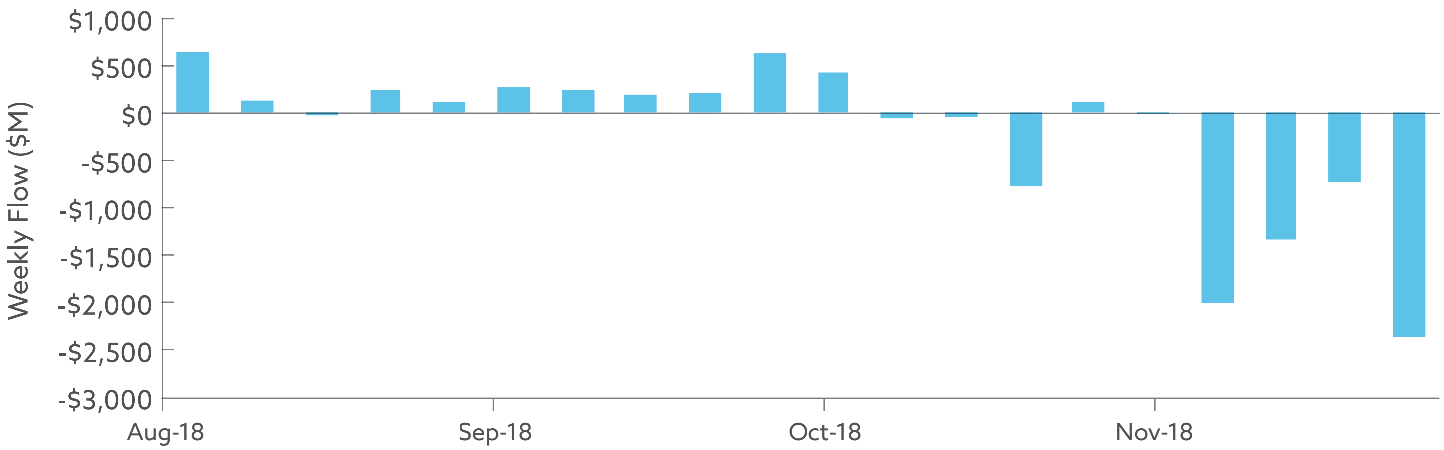
## BANK LOANS

Technical conditions have weighed heavily on the US bank loan market since mid-November. After material inflows throughout most of 2018, outflows from both mutual funds and ETFs have been substantial.[9] Market rhetoric has also shifted, as outflows and negative performance have refocused attention on loan deal structures. Although we believe fundamentals have not changed over this period, flows should drive the direction in the near term.

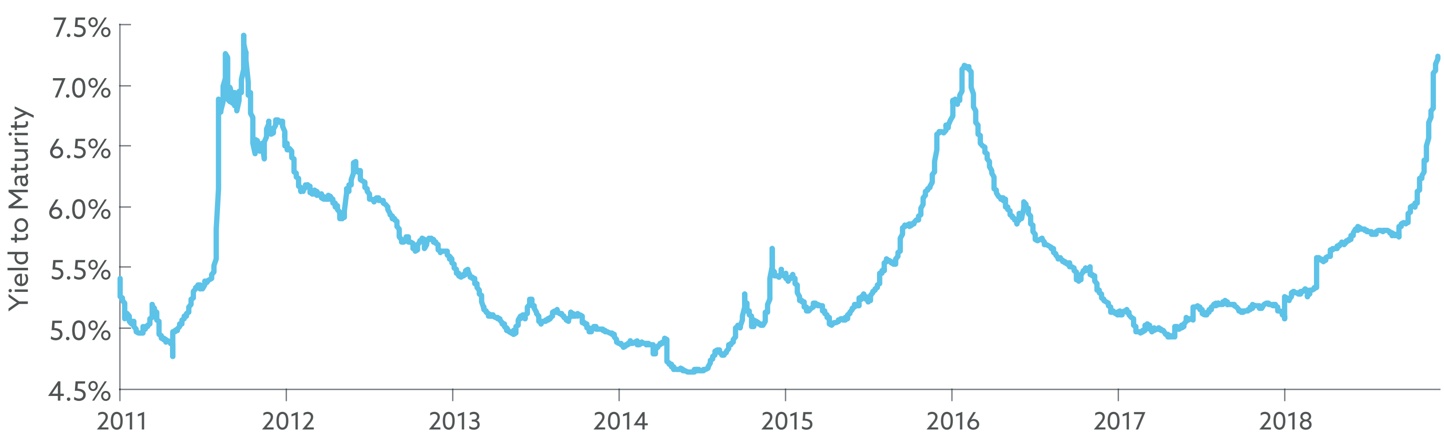
The fundamental backdrop remains constructive. We do not see a material increase in defaults in the near term and expect the default rate for the benchmark to remain below the historical average of 3% over the next year.[10] Companies have not rung any alarm bells that their underlying fundamentals have changed. Corporate earnings are expected to decelerate, but remain positive in 2019.[11] US GDP growth is expected to decelerate next year, but would be relatively strong at the forecasted 2.5% when compared to expected global growth.[12] While the CLO market paused for the holidays, we expect deals to continue to price in 2019. The pace is likely to slow, however.

Covenant-lite, 2nd lien and loan-only structures have all risen, as has loan leveraged buyout (LBO) activity. This has increased investor concern regarding the loan market, and is any easy target for market pundits. However, each concern has its own idiosyncratic features. Covenant-lite loans have been a large majority of the market for years, a phenomenon around the strength of the market. As a result, most new issuance has contained covenant-lite structures. We focus on metrics such as cash flows and collateral. Given the recent volatility, we expect covenant quality to improve until the market steadies, which we already saw in November.[13] We tend to avoid 2nd-lien issuers, focusing on 1st liens. Finally, the rise in LBO activity was highlighted by a trio of large offerings in the chemical, manufacturing and software sectors in the third quarter of 2018. We will continue to research such offerings on a bottom-up, loan-by-loan basis, again focusing on metrics such as cash flows and collateral.

### SIGNIFICANT OUTFLOWS HAVE DRAGGED DOWN LOAN PRICES[9]




### BANK LOAN YIELD BACKING UP TO PREVIOUS HIGHS[14]




(9) Morningstar. Based on estimated weekly flows for the US OE Bank Loan category (including ETFs) through 12 December 2018. (10) S&P Global Market Intelligence. 27 December 2018. (11) FactSet. 27 December 2018. (12) IMF. World Economic Outlook, October 2018. (13) S&P Global Market Intelligence. 18 December 2018. (14) S&P Global Market Intelligence. YTM of the S&P/LSTA Leveraged Loan Index. 31 December 2018.

## EQUITIES

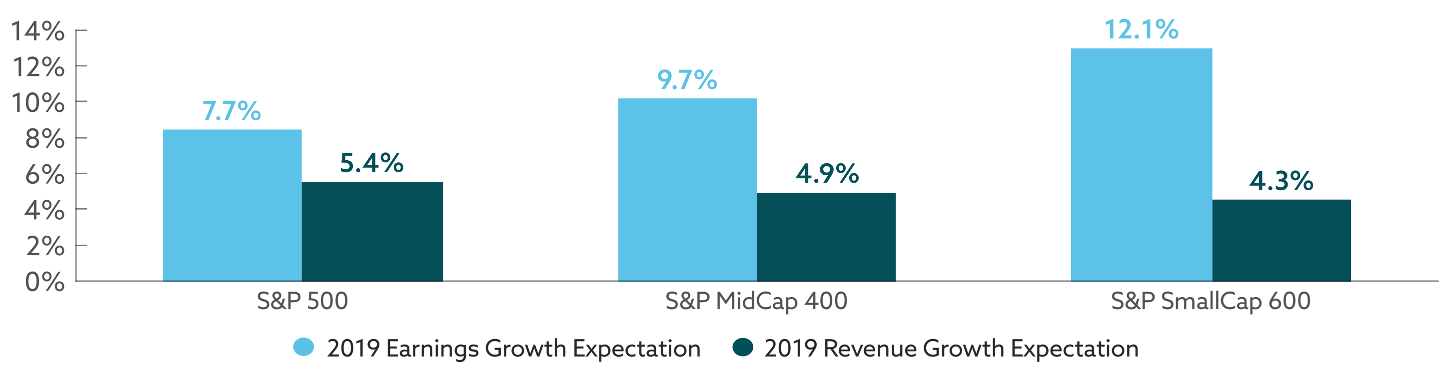
We see the US equity market environment as supportive going into 2019, though trade remains a significant wild card. Following the correction in the fourth quarter, equity market valuations and earnings growth expectations have been reset near long-term averages (roughly 8% earnings growth on 5% revenue growth within large caps). We continue to expect margin expansion, as companies continue to discuss reducing expenses, making technological advances to improve efficiency and keeping headcount fixed from a cost standpoint. Although late-cycle fears persist, consensus expectations are for economic growth of 2.5% in 2019, only a slight moderation from growth seen in 2018.[15] We would expect increased market volatility amid tariff and trade uncertainty, as well as Federal Reserve overtightening fears. Fed policy was less accommodative in 2018. Going forward, the pace of monetary policy could be more dovish than expected if benign inflation expectations continue despite the much-improved labor market.

We were surprised by the underperformance of the Financial sector in 2018, particularly in banks. The set-up for bank stocks looked constructive going into 2018: normalizing interest rates, improved business confidence, healthy credit markets and an improved economic backdrop. Late-cycle fears began to be discounted into bank prices as the year unfolded. Fears of credit deterioration, slower loan growth and lower net interest margins (given the flattening yield curve) all negatively impacted bank prices. We remain optimistic going into 2019 given the continued improvement of bank operating fundamentals. In general, we find many holdings offer both well capitalized balance sheets and shareholder-friendly capital return plans.

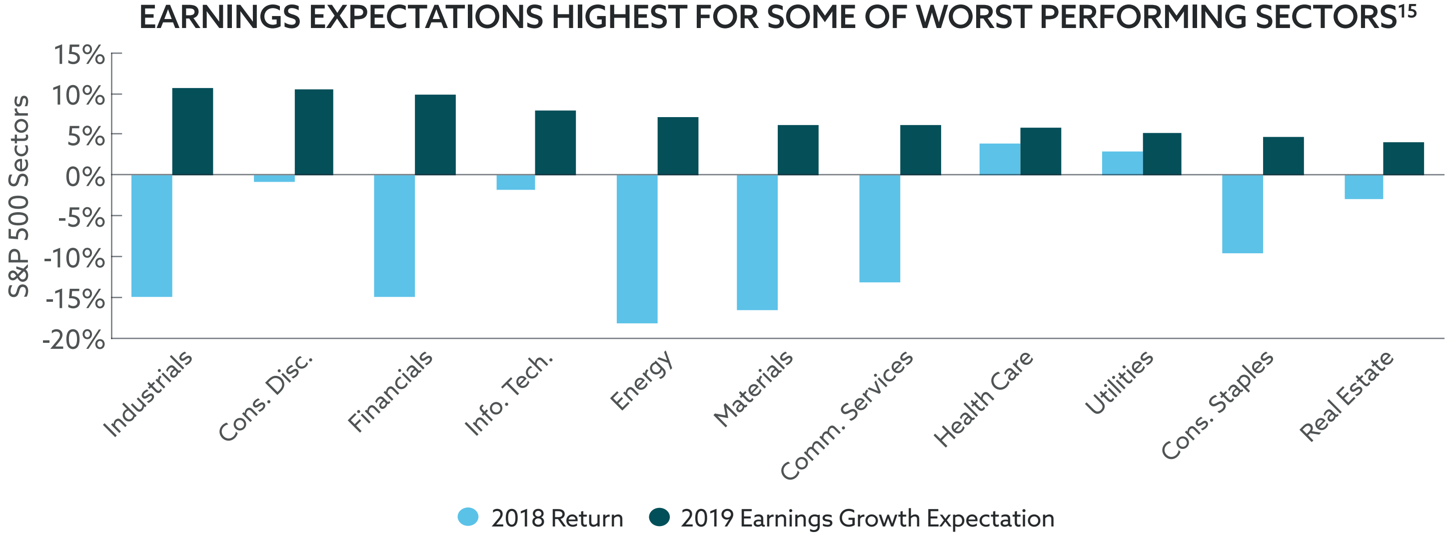
As bottom-up investors, we make investment decisions based on valuations and underlying operating fundamentals, but remain aware of market sentiment and expectations. Continued excessive pessimism surrounding trade and the Fed's rate path in 2019 could create opportunities for patient investors. From our experience, we have seen that equity valuations can dislocate from underlying fundamentals in market environments characterized by extreme fear and uncertainty. This creates opportunities to buy companies temporarily out of favor that we view as high quality.

Given the volatility of the fourth quarter, areas of focus entering the year include the Energy and Consumer Discretionary sectors. They have faced heavy selling, and there could be opportunities depending on how large discounts grow and where names are in the cycle. These sectors, along with Financials, also have relatively strong earnings growth expectations for 2019.[15] Conversely, Utilities and REITs outperformed in 2018. There can be idiosyncratic buying opportunities, but overall we do not view the valuation levels of these equity sectors as attractive.

### DESPITE DECELERATION, HEALTHY EARNINGS GROWTH EXPECTED IN 2019[15]




### EARNINGS EXPECTATIONS HIGHEST FOR SOME OF WORST PERFORMING SECTORS[15]




(15) FactSet. 27 December 2018.

## COMMERCIAL REAL ESTATE

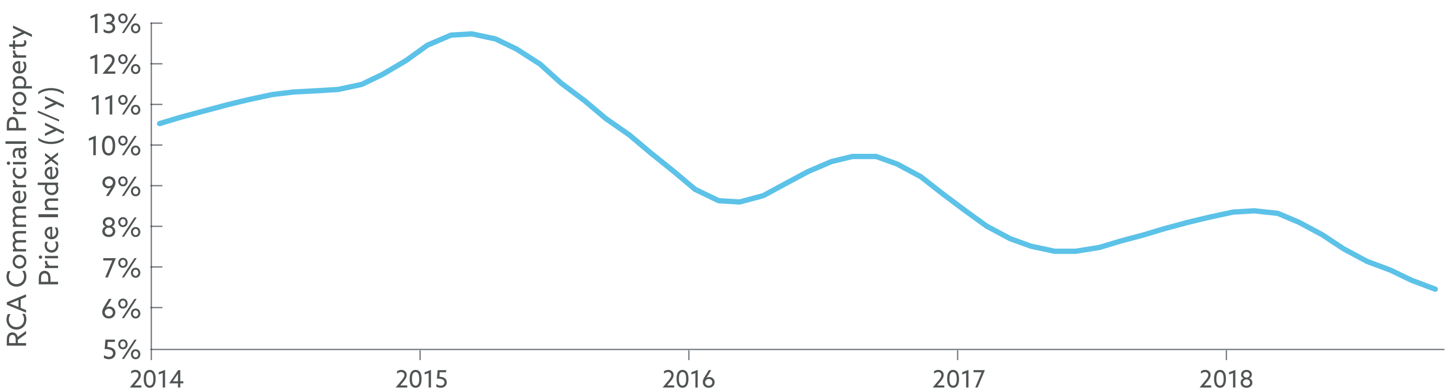
The US commercial real estate market is late cycle, but we believe it still has room to run. This view is based on fundamentals, which we believe are supportive for most property types and in most markets. Growth remains positive, but is decelerating, as one would expect at this point in the cycle.[16]

There are three general concerns within the CRE market. The first concern is property valuations are at or near all-time highs. The second is cap rates are at or near all-time lows. The third is CRE investors have a historically large amount of capital waiting to be deployed. It is both debt and equity capital, exacerbating the valuation problem. It is also an issue specifically for debt, because it could lead to deteriorating loan underwriting standards.

We feel there are mitigating factors that support our fundamental view. Cap rates are at or near all-time lows and the average cap rate spread over Treasuries is inside of long-term averages. However, cap rate spreads remain well above 2006/07 levels.[17] CRE investors are attempting to deploy a large amount of capital, especially on the debt side. However, we believe the four major commercial mortgage debt providers – life insurance companies, banks, government-sponsored entities (GSEs) and issuers of commercial mortgage-backed securities (CMBS) – are currently holding the line regarding underwriting standards. Finally, oversupply in the form of too much construction has traditionally been the primary driver of a drop off in fundamentals. But current rates of construction, especially when viewed as a percentage of existing inventories, continue to run at or slightly below historical averages.

Within commercial mortgage loans, we will continue to research new investments on a loan-by-loan basis, and believe 2019 will offer opportunities. Within CMBS and REITs, we anticipate taking a more tactical approach in 2019. As stated, our view remains positive on CMBS underwriting standards, so we expect new deals that could offer investment opportunities from a credit perspective. From a portfolio management standpoint, CMBS can act as an avenue of investment when corporate bonds experience volatility. We remain bullish on REIT credit, as the sector is underpinned fundamentally by earnings (a majority of companies met or exceeded third quarter expectations), balance sheets that we believe remain in good shape and low default expectations. As with CMBS, REITs can be a tactical opportunity in times of volatility in the broader corporate bond market.

### COMMERCIAL REAL ESTATE STILL GROWING, BUT AT DECELERATING PACE[16]




### CAP RATE SPREAD AT POST-CRISIS LOW, BUT WELL ABOVE PRE-CRISIS LEVELS[17]


(16) Bloomberg. 19 December 2018. (17) Bloomberg, FactSet, PPM. 19 December 2018.

## ABOUT PPM AMERICA

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The **ICE BofAML US High Yield Index** provides a broad measure of below investment grade, USD-denominated fixed rate corporate debt. It includes corporate bonds with risk exposures to countries that are members of the FX-G10, Western Europe or territories of the US and Western Europe.

The **RCA Commercial Property Price Index** was developed and is published by Real Capital Analytics. It is a transaction-based index that measures commercial real estate price movements using repeat-sales regression methodology.

The **S&P 500 Index** provides a broad, market capitalization-weighted measure of US large cap stocks. It includes approximately 500 publicly-traded stocks of the largest US companies.

The **S&P MidCap 400 Index** provides a broad, market capitalization-weighted measure of US mid cap stocks. It includes approximately 400 publicly-traded stocks of mid-sized US companies.

The **S&P SmallCap 600 Index** provides a broad, market capitalization-weighted measure of US small cap stocks. It includes approximately 600 publicly-traded stocks of small US companies.

The **S&P/LSTA Leveraged Loan Index** provides a broad, market value-weighted measure of US institutional leveraged loans. It includes the institutional tranches of loans syndicated to US loan investors.

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