

BEWARE OF BULL MARKET COMPLACENCY



**WILL M&A AND IPO POTENTIAL
BECOME REALITY?**

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HIGH YIELD

Letter From The CIO

2024 proved to be a very positive year for investors. The S&P 500 Index rose 25.0%, leverage loans added 8.9%, high yield bonds returned 8.2% and investment grade corporate bonds increased 2.1% (with an even stronger excess return).¹

The strength in the economy and corporate fundamentals surprised versus expectations and drove these returns. Market participants began 2024 worried about numerous headwinds: a potential economic slowdown driven by higher interest rates; the impact of these higher rates on corporate margins; sticky inflation and the resulting constraint on the Federal Reserve’s (Fed) ability to lower rates; uncertainty surrounding the US election; and what appeared early in 2024 to be already elevated valuations. Instead, these fears largely failed to materialize. US GDP growth remained robust throughout the year while companies maintained – and in many cases increased – margins.

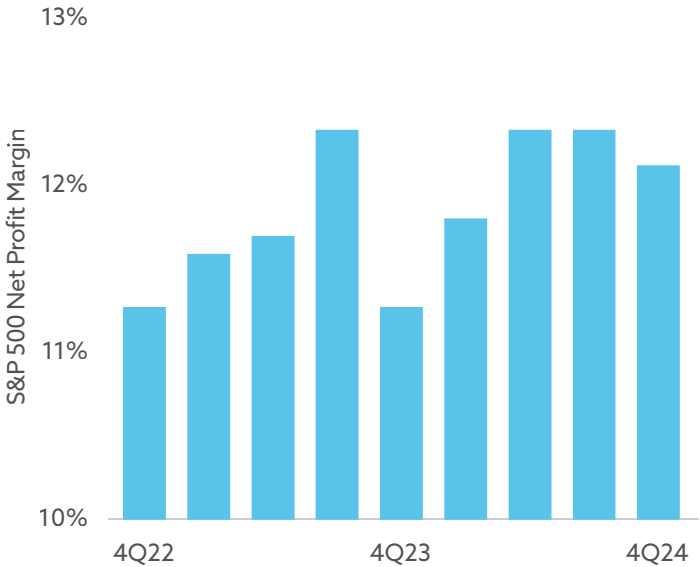
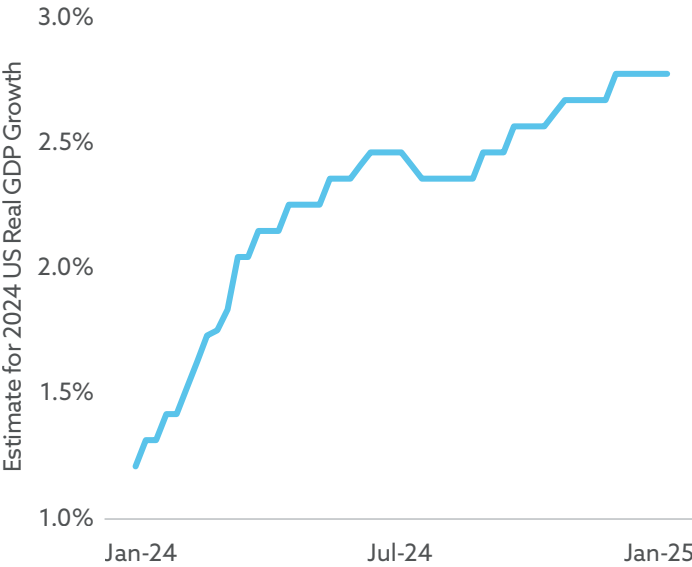
In the public fixed income universe, credit spreads have been tightening since the end of 2022, which has bolstered returns but has left the market with somewhat stretched valuations. This period of tighter spreads has coincided with, and has perhaps been driven by, an almost insatiable search for yield by investors across the globe, backed by the constructive fundamental trends mentioned above.

This period has also brought changes in market structure that are likely to remain important in the years to come. For example, private credit has continued to grow as an asset class, given a widespread belief that it offers advantages in many cases to both investors and issuers versus the broadly syndicated loan market. Public corporate bonds have also experienced changes in the way investors transact in the market with the strong growth in portfolio trading, a technique used to quickly gain or reduce exposure to a basket of issues more efficiently and at lower transaction costs than trading individual bonds.² In parallel, numerous bond ETFs were launched to meet growing fixed income demand, as managers offered trading strategies to take advantage of the tax efficiency of this structure.³

Unfortunately, as is often the case following periods of strong market performance, “bull market complacency” can creep in as investors lose sight of the fundamentals that anchor valuations. Some may even begin to believe that these new structures and techniques by themselves can mitigate credit risk. For example, some have argued that portfolio trades allow investors to own a sufficiently diversified basket of bonds that obviates the need to understand the credit risks inherent in the individual names. The logical extreme of this view is that the credit quality of each distinct issuer is irrelevant.

At PPM, we strongly reject this point of view. Though it may seem counterintuitive, the importance of credit fundamentals to portfolio positioning only grows as

2024 FUNDAMENTALS SURPRISED DESPITE INFLATION, HIGHER INTEREST RATES⁴



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spreads tighten and valuation dispersion lessens. When the next downturn arrives, we believe those that prepared during the good times will generate far better results versus those that trade “baskets of risk.”

History provides many examples of bull market complacency that were subsequently proven to be misguided and costly to investors. In the mid-1990s – coincidentally the last economic soft landing – there was a widespread view that bond spreads would not go wider due to the benign macro environment and strong technicals in the market. Then the Asian currency crisis of 1997 showed this view to be wrong, followed a year later by the demise of Long-Term Capital Management. Technology start-ups flourished in the late 1990s, with seemingly any tech company able to raise money through an IPO regardless of the viability of their business plan. Then the dot.com bubble burst in 2000, sending the NASDAQ Composite down almost 70% over the course of the next year.⁵ In the mid-2000s, many investors believed that home prices would never go down and lent aggressively to homebuyers with a reckless disregard for the credit quality of the borrower. The Global Financial Crisis painfully disproved that particular strain of bull market complacency.

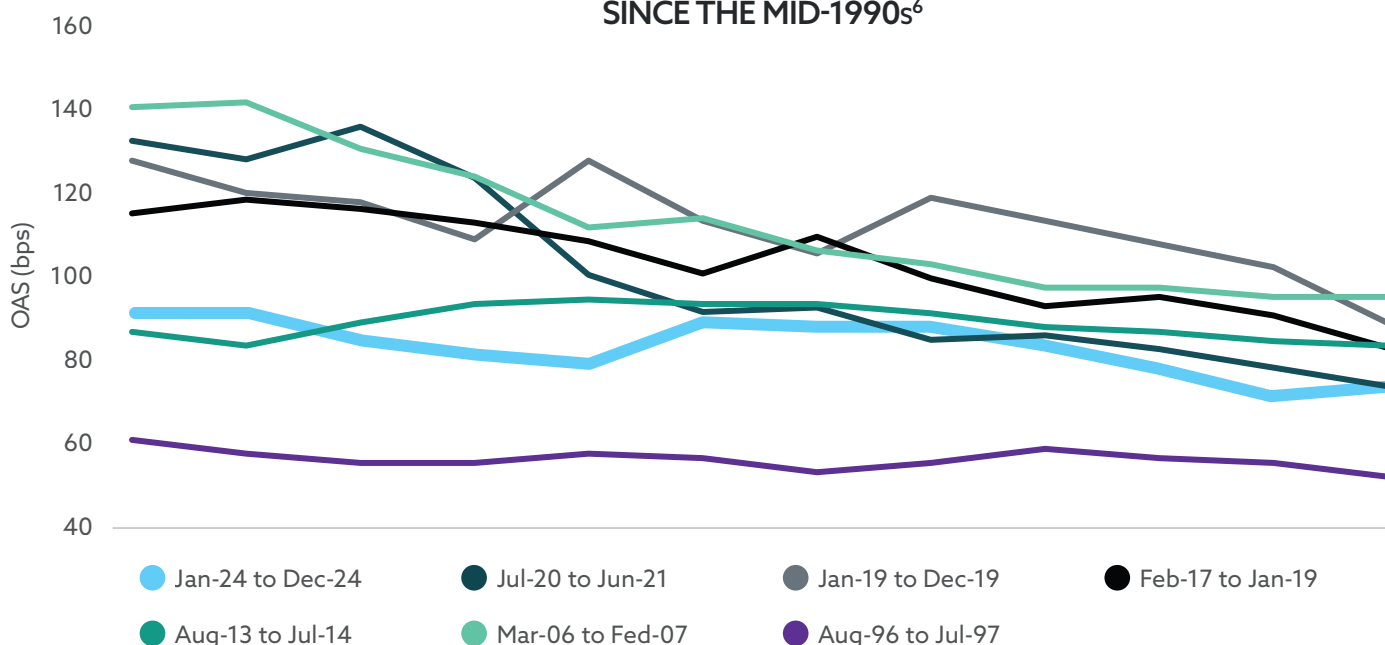
We believe managers need to consistently invest with such examples in mind. When choosing a manager, an investor should understand if a prospective manager has the awareness and record of successfully generating alpha throughout the credit cycle, and not only in bull markets.

Our investment approach and philosophy are anchored on the view that credit quality will ultimately matter, even when the macro risks mentioned earlier appear to have passed. Macro risks are not the only drivers of poor returns. In the relentless search for outperformance, investors need to intelligently position their portfolios given all factors, including fundamentals, technicals and valuations. While keeping an eye on tight spreads, we believe there are areas in fixed income that [present investors the opportunity](#) to take advantage of currently elevated yields and the positive demand technicals that they support.

In the public corporate bond market, spread levels are compressed between sectors and rating categories (e.g., A-BBB, BB-B), despite fundamental differences in credit risk. Our portfolio managers are recommending and implementing moves up-in-quality, rotating out of riskier names that we believe trade too tight and into higher-rated bonds with minimum spread give up.

We also see value in Investment Grade Private Credit (IGPC), an asset class that can help investors meet multiple objectives – higher yields, stronger credit quality, tighter covenants that provide investor protections and more attractive spreads relative to public corporates. At PPM, our IGPC strategy team sees increased interest in the asset class which we believe should continue to enjoy several tailwinds in today's environment.

IN NOVEMBER, IG SPREADS REACHED THEIR TIGHTEST LEVEL SINCE THE MID-1990s⁶



(5) FactSet. The NASDAQ Composite peaked on 10 March 2000 and declined 68% on a price basis through 4 April 2001. (6) FactSet. Monthly OAS of the Bloomberg US Corporate Bond Index. 8 January 2025.

In Commercial Real Estate, another private asset class that can complement public bond portfolios, the correction in the Office sector is still ongoing but we anticipate the solid fundamentals of the other major property types to remain in place. In addition, a rise in maturities in 2025 is likely to provide ample investing opportunities in these other property types.

Prevailing yields in fixed income asset classes today offer investors attractive alternatives to equities to meet their investment objectives. However, with tight spreads and compression along the quality stack, careful credit selection will likely be a significant differentiator for success in the coming year and beyond.

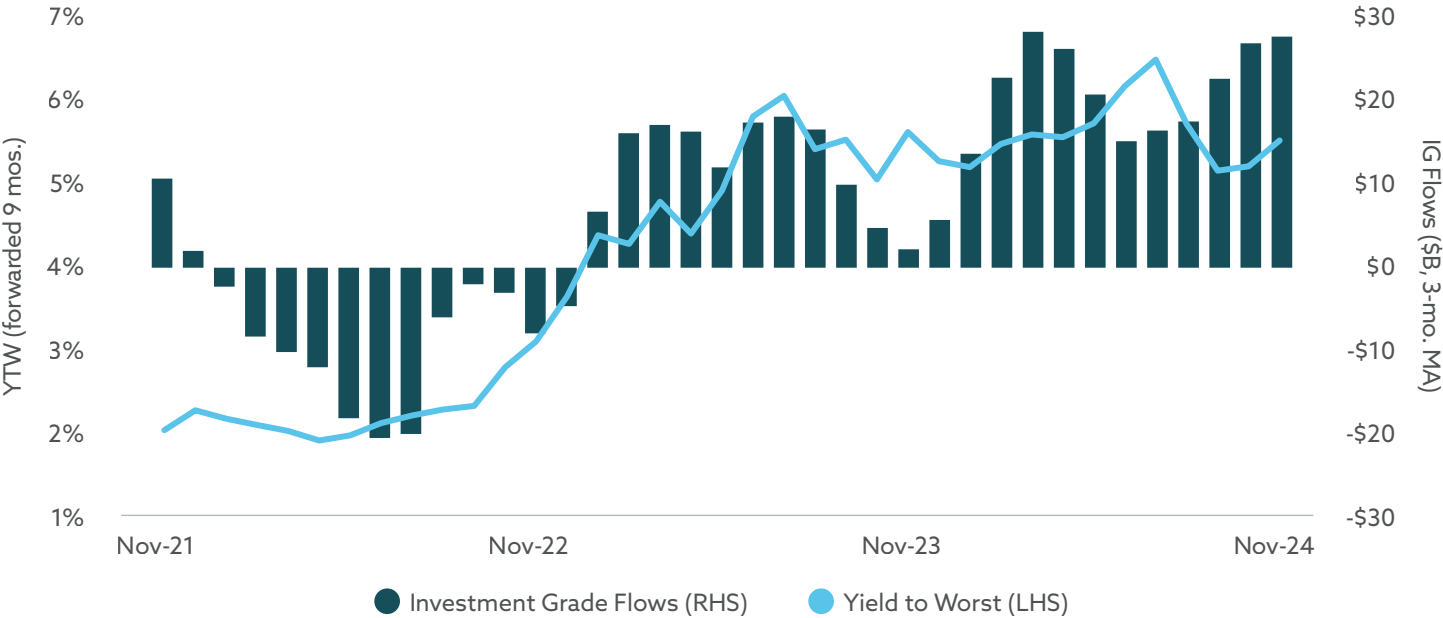


CRAIG SMITH, CFA
President, CEO & CIO



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Deputy CIO

INVESTORS HAVE RESPONDED WELL TO HIGHER YIELDS⁷



(7) FactSet, Morningstar. As generated on 9 January 2025. YTW for the Bloomberg US Corporate Bond Index is forwarded 9 months to show the lagged effect yield movements have on flows (meaning the yields shown are from Feb-21 through Feb-24). IG flows are aggregated from Morningstar's US OE Corporate Bond, Intermediate Core Bond, Intermediate Core-Plus Bond, Long-Term Bond, Short-Term Bond and Ultrashort Bond categories (including ETFs).

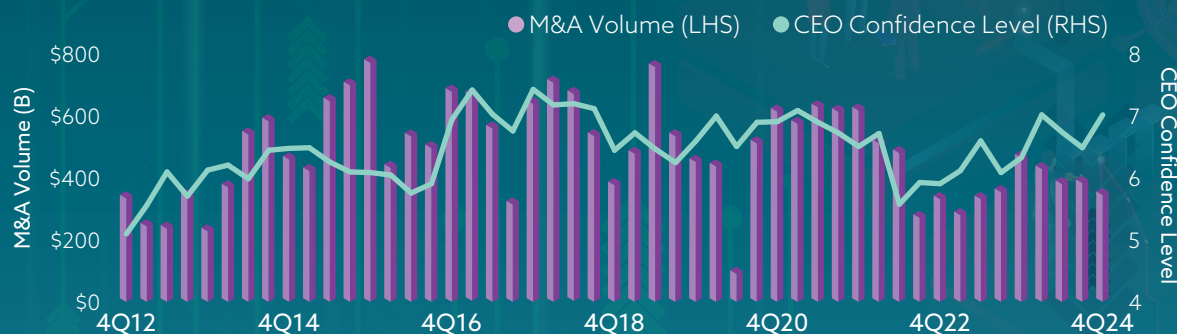
LET'S MAKE
A DEAL

Will M&A and IPO Potential Become Reality?

As we kick off the new investment year, numerous market prognosticators are calling for an uptick in both M&A and IPO activity. The economy seems to have pulled off a soft landing; the S&P 500 hit all-time highs 57 times during 2024; and CEOs are optimistic about the future.¹ Throw in a new presidential administration that should be pro-business, and the stage seems set for a rebound. Let's take a closer look at current conditions to see how likely the potential may be for M&A and IPO activity to flourish in 2025 and provide opportunities for investors.

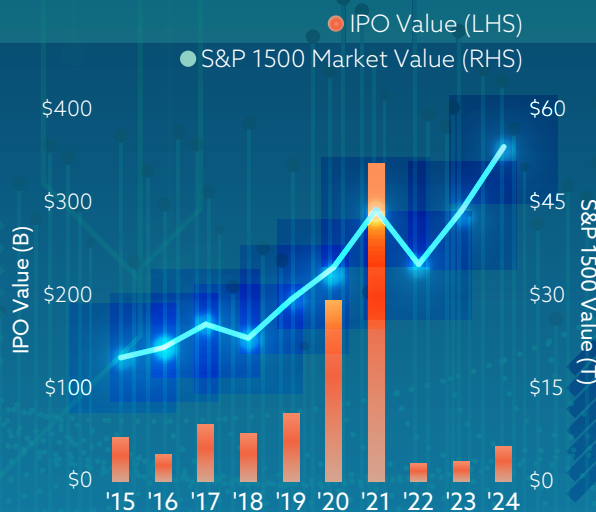
RECENT M&A ACTIVITY LAGS CEO CONFIDENCE²

CEO confidence is the highest it has been since the beginning of the Fed tightening cycle. However, M&A activity still remains below pre-tightening levels. Outside of Q4 2023, a gap has existed between the amount of deals and the optimism of business leaders over the past two years. A catalyst to bridge that gap could be the potential for deregulation from the second Trump administration.



IPO VALUE BELOW PRE-COVID LEVELS AS PUBLIC EQUITY INCREASES³

The zero interest rate environment during the pandemic ignited a flurry of IPOs in 2020 and 2021. But when the Fed had to increase rates to combat inflation, IPO activity fell precipitously to below pre-COVID levels. This coincides with a significant increase in the market value of stocks. In our view, the capacity for IPOs exists, along with a growing need for them as private equity investors seek exit opportunities for their deals in 2025.



(1) PBS. "How the stock market defied expectations in 2024, by the numbers." 26 December 2024. (2) Bloomberg. Quarterly data for total deal volume of North American M&A activity, which includes pending, completed, terminated, proposed and withdrawn deals and corresponding monthly results of the CEO Confidence Index, which measures CEO's business outlook for the next 12 months on a scale. 10 is an "Excellent" outlook. 9 January 2025. (3) Bloomberg and FactSet. Yearly total IPO value and S&P Composite 1500 Market Value. 9 January 2025.

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KEY TAKEAWAYS

- > US private equity (PE) investors have experienced a pickup in exit activity and signs of a fundraising thaw; we expect those areas of the market to improve in 2025
- > We also believe deal flow will remain robust, especially for co-investments
- > Despite market expectations for a strong year, underwriting and due diligence will remain paramount as inflation, geopolitics and macroeconomic uncertainty remain risks

A CHANGING NARRATIVE

With the Fed beginning a rate cutting cycle in September and a Republican government taking over in January, the market consensus is for a bright 2025 for US PE. We agree, but we also believe times of exuberance are not times to forgo extensive underwriting and due diligence.

Since 2022, when the Fed's rate hiking cycle significantly raised interest rates, the PE market has faced headwinds. Exit activity slowed, led by a reduction in IPOs. However, 2024 brought a pickup in exit activity, which we expect to continue in 2025. There has been a surge in single-asset continuation vehicles, increasing distributions to limited partners (LPs). Given today's lower interest rate environment, some general partners (GPs) are refinancing debt facilities and executing dividend recapitalizations to provide LPs with liquidity.

Fundraising activity had slowed for all but the biggest names, resulting in smaller dollar amounts raised amid longer time frames. We observed some thawing in 2024 and believe the fundraising market could improve this year. When the pace of asset sales increases, distributions back to LPs also increase, which can increase LPs capacity to commit fresh capital. Further, more recent PE vintages may be investing at better valuations.

Investment activity has already rebounded, and we expect robust deal flow again in 2025. This includes an area of focus for PPM – co-investment deals. Lower interest rates could bolster deal flow; however, cheaper borrowing costs may also lead to elevated valuations.

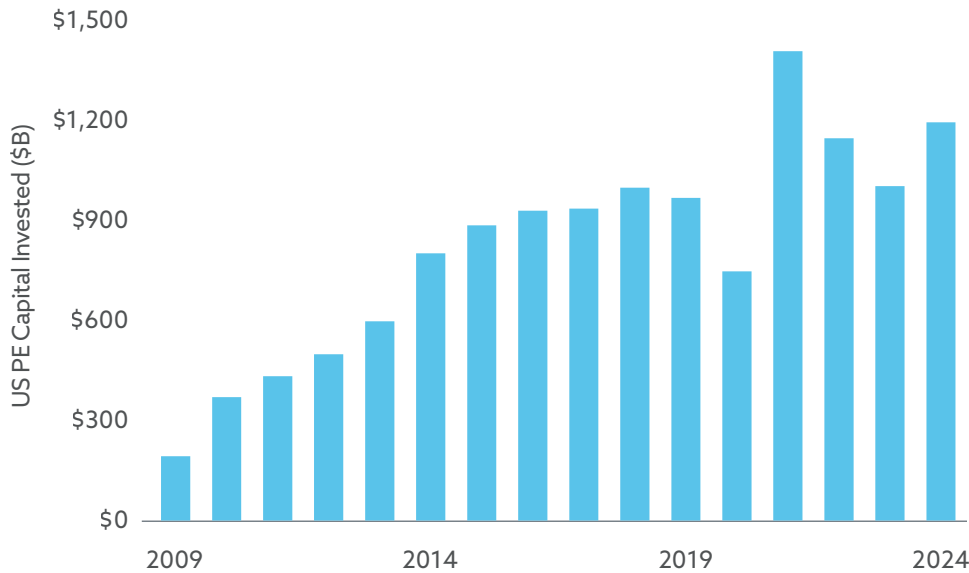
TECH REMAINS AT THE FOREFRONT

The Technology sector has been a focal point for PE investors, and we expect it to remain so. AI and machine learning seem to be discussed at every meeting. These trends impact other sectors – maybe all sectors – given technology needs are embedded in most businesses.

DON'T LOSE SIGHT OF THE RISKS

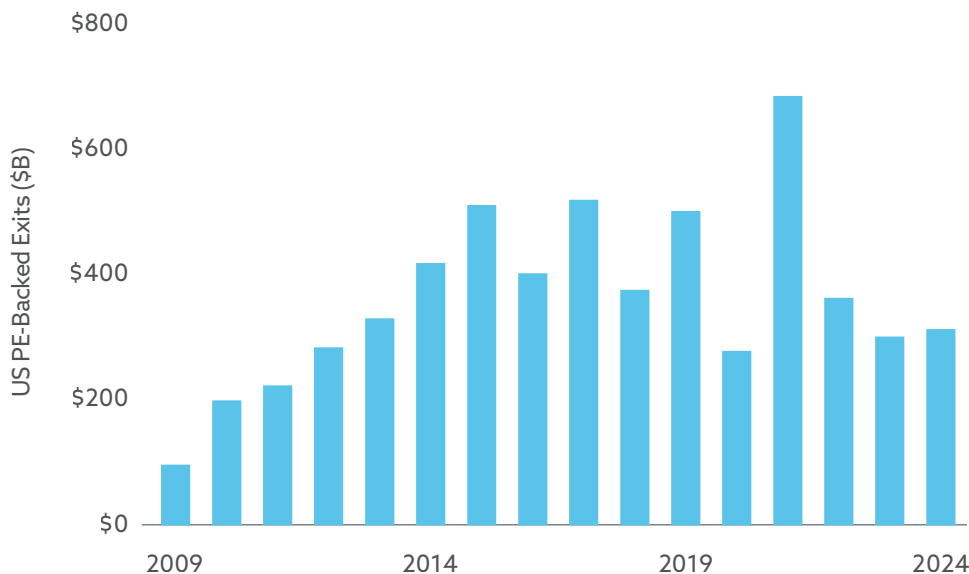
The macro drivers we have discussed come with risks. The Fed's current cutting cycle is underpinned by the assumption inflation is under control, but it may not be. While we believe portfolio companies are better prepared to manage higher rates, an uptick in inflation could lead to slower growth and higher input costs. The economy has been supported by consumer spending, but that strength may ebb in 2025. Specific to PE, public equity markets have outperformed over the last two years, and continued outperformance could impact flows of future dollars into PE.

WE EXPECT DEAL FLOW TO REMAIN ROBUST, ESPECIALLY FOR CO-INVESTMENTS¹



We have witnessed robust co-investment deal flow in recent years and expect it to continue in 2025. For all types of deals, activity rebounded in 2024 and we expect it to remain elevated this year. The lending environment remains open and continues to be favorable for PE deals. Interest rates could be a tailwind here if market yields come down (despite Fed cuts in Q4 2024, market yields finished the year near their highest levels). Single-asset continuation vehicles are another driver. We mentioned how distributions back to LPs can increase their capacity to commit fresh capital, and GPs can use that capital to drive continued deal volume.

EXIT ACTIVITY COULD INCREASE IN 2025²



PE exit activity steadied in 2024 following two down years, and we expect this area of the market to improve in 2025. We already discussed two drivers – single-asset continuation vehicles and refinancings/dividend recapitalizations. Further, the capacity for IPOs exists, along with a growing need for them, as PE investors seek exit opportunities for their deals this year.



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KEY TAKEAWAYS

- > With credit spreads at multi-decade tights, credit selection will likely be paramount for 2025
- > Strong underlying demand should remain in place as yields remain historically attractive
- > Political appointees and increased M&A should lead to an acceleration in sector differentiation

US investment grade spreads tightened further in Q4 2024, particularly during the first half of the quarter after the Fed began its easing cycle and a Republican sweep in the US election stoked hope for tax cuts and deregulation.¹ After trading as tight as 71 bps, a multi-decade low, the spread of the Bloomberg US Credit Index (Index) finished the quarter 7 bps tighter to 77 bps. Overall the spread tightened 16 bps in 2024.

However, the Index produced a total return of -3.04% during the quarter as US Treasuries sold off, reducing the 2024 total return to 2.03%. Drivers included the market pricing in fewer rate cuts in 2025 and the prospect of increasing issuance as the Trump administration is expected to continue to run, or even increase, the federal deficit. The 10-year US Treasury yield rose 77 bps during the quarter to 4.58%, just below its high level of the year.²

YIELDS DRIVING DEMAND

Fixed income yields remain attractive on a long-term basis, especially versus the equity market, and we expect elevated demand to continue across our market. Investment grade experienced its 10th consecutive quarter of inflows (\$42B), up from the previous quarter (\$26B) and Q4 2023 (\$24B).³

But that demand has also led to spread compression across all rating buckets, reducing the risk-adjusted return. As a result, we feel now is the time to get closer to home risk-wise and wait for opportunities to deploy capital

MARKET DRIVERS TO WATCH

The good news is that we expect those opportunities to come. Politically, investors are eager to see how campaign trail rhetoric translates into real policy changes. Deregulation and lower taxes (both corporate and individual) would most likely be tailwinds for performance. However, the Trump administration's undefined policies of higher tariffs and enhanced deportation actions may leave markets susceptible to increased volatility in both inflation and GDP.

M&A may also provide numerous opportunities for capital deployment in 2025. High CEO optimism, more friendly regulatory bodies and equities at all-time highs should lead to a heightened M&A landscape where it will be particularly important to avoid the acquirers and own the acquirees.

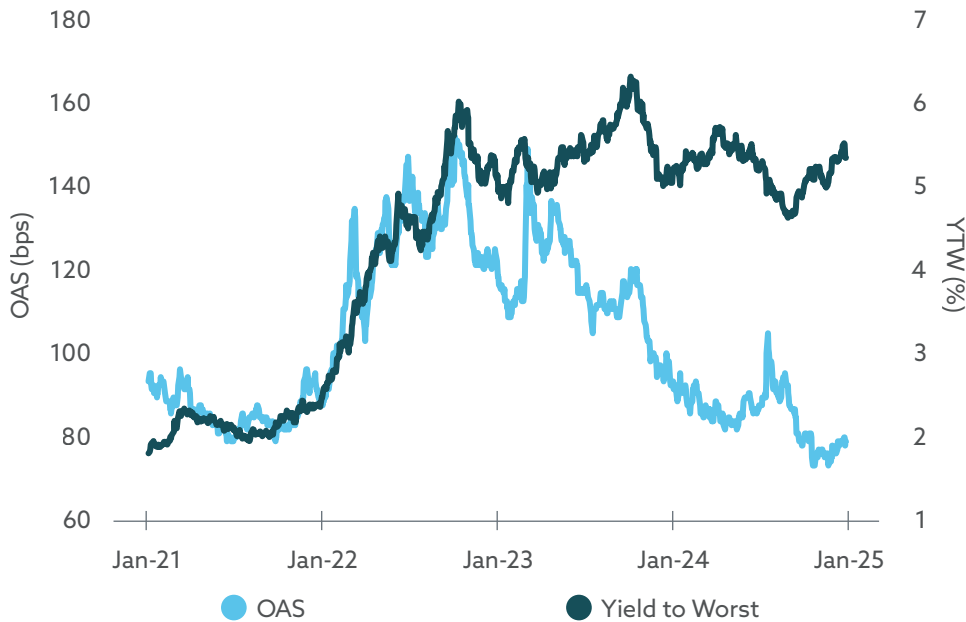
POSITIONING TO BEGIN 2025

While starting 2025 closer to home from a risk perspective, PPM still found places to put money to work. We are overweight Banks as less regulation may lead to less issuance which should be beneficial for performance. For strategies that allow, we also added MBS on the back of significant 2024 underperformance.

Overall, our current up-in-quality bias provides ample flexibility to reposition the portfolio tactically. We will continue to lean into our credit research capabilities to make investment decisions, as security and sector selection will be vital for 2025 in our view.

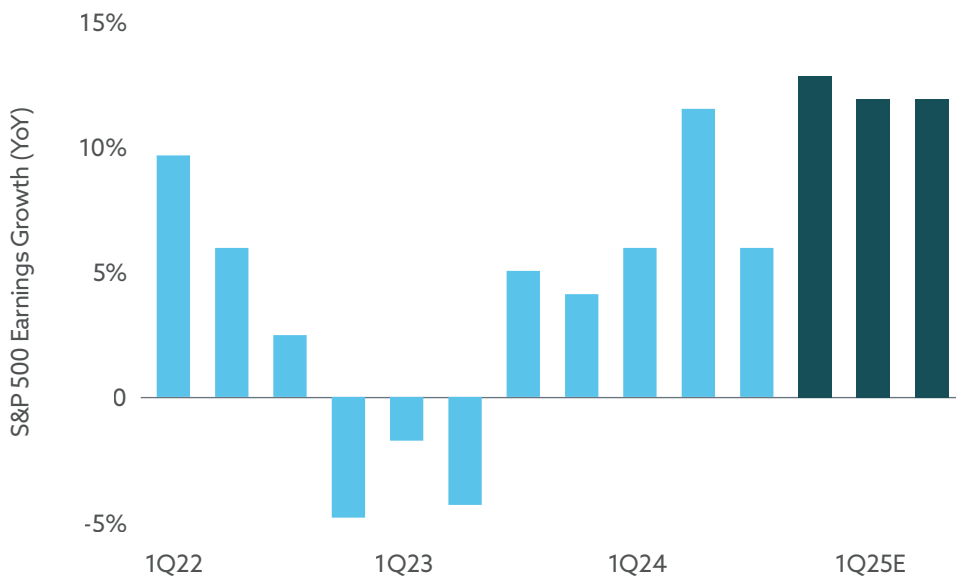
(1) Unless indicated, data sourced from Barclays. 2 January 2025. (2) FactSet. 2 January 2025. (3) Morningstar. Based on monthly flows for the US OE Intermediate Core Bond category (including ETFs) through 31 December 2024.

TIGHT SPREADS AND HIGH YIELDS FAVOR CREDIT SELECTION⁴



Early in 2025, economic growth remains strong; the job market appears balanced; and earnings growth is healthy. However, risk assets appear to be priced accordingly with credit spreads at multi-decade tights. As such, we believe credit selection will be vital in 2025.

DOUBLE DIGIT EARNINGS GROWTH EXPECTED⁵



Corporate fundamentals, in our view, remain on solid footing with leverage steady but at a high level. In fact, earnings growth is expected to be double digits for each of the next few quarters. Even discounted, these projections represent a sizable shift upward from the average of the previous 10 quarters (3.5%).

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Head of Leveraged Credit

**JOHN BROZ**

Portfolio Manager

**KARL PETROVICH**

Portfolio Manager

KEY TAKEAWAYS

- > The high yield credit cycle benefits from positive trends in ratings, a lower distress ratio and a below average default outlook
- > Economic growth has been resilient, while we remain focused on any cracks in the labor market
- > We see value in natural gas-exposed Energy names, Financials and Telecommunications; leveraged loans still offer attractive income

MARKET PERSPECTIVE

We expect the supportive elements of the high yield credit cycle to continue in 2025. Economic and corporate profit growth are positive. The upgrade/downgrade ratio has stabilized (\$27B in net upgrades for 2024) and the distress ratio (4.04%) is well below long-term averages (10.88% since 2006), signaling a benign default outlook.¹

Valuations generate much debate with spread levels near multi-decade lows. Yield levels above 7% still offer intriguing long-term return prospects. The ICE BofA US High Yield Constrained Index – at over 50% BB and only 12% CCC – is also higher quality than in past cycles.² We believe the key macro questions are around employment, inflation and interest rates. We continue to watch for any cracks in what has been a resilient US employment picture. Inflation is contained, in our view.

The technical picture remains robust. The asset class experienced a fifth straight quarter of inflows (\$1B).³ High yield companies issued \$50B in bonds during the quarter, above the \$42B issued in Q4 2023. However, net supply has been moderate.

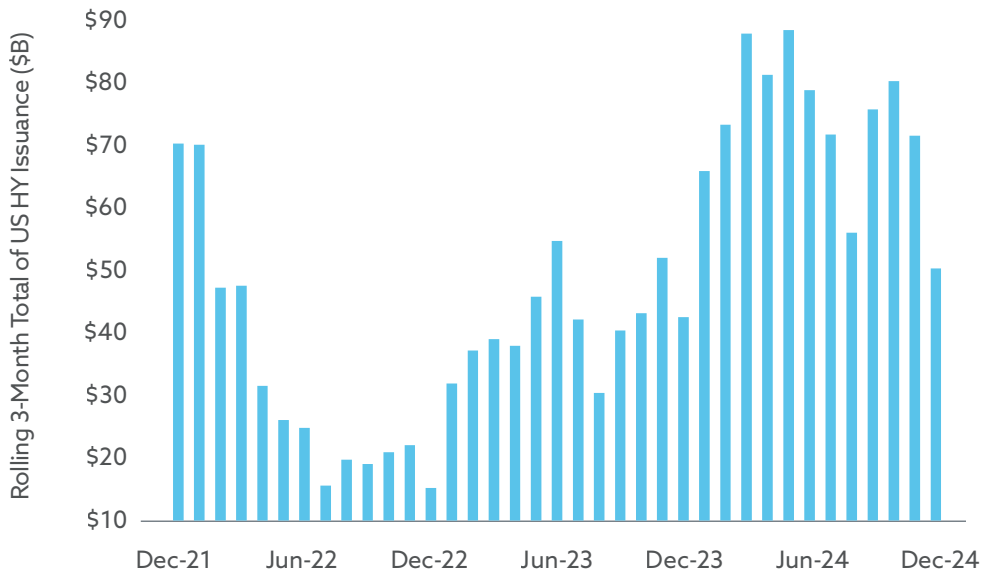
POSITIONING TO BEGIN 2025

Overall, we see value in the core of the market – spreads in the 200-400 bps range – across ratings. Dispersion in credit spreads declined in 2024 but still screens high relative to spread levels.

Thematically, we like select BBB rated credits over higher-quality BB risk. Sector-wise, we favor natural gas-exposed credits in the Energy sector over oil-exposed names and are overweight Financials and Telecommunications. For clients that have the flexibility to own leveraged loans, we favor an out-of-index allocation to earn attractive current income.

(1) Unless indicated, data sourced from BofA Global Research. 2 January 2025. (2) Rating data sourced from ICE Data Services through 17 January 2025. (3) Morningstar. Based on monthly flows for the US OE High Yield Bond category (including ETFs) through 31 December 2024.

SUPPORTIVE ECONOMIC CONDITIONS ENABLED HY ISSUANCE⁴



Following the onset of Fed rate hikes in 2022, and especially after the 75-bp increase in July of that year, high yield issuance plummeted. A number of issuers remained on the sideline due to the uptick in financing costs and the potential for a recession. However, as the economy kept showing signs of resilience and the soft landing scenario became more likely, issuance rebounded in 2024, once again reaching pre-tightening levels.

DISPERSION DECLINED IN 2024, BUT STILL SCREENS HIGH RELATIVE TO SPREADS⁵



Dispersion in the high yield market declined from 72% in January 2024 to 64% to end the year. However, spreads tightened 47 bps over that same time period. As a result, dispersion is still high relative to spreads, which indicates that sector and credit selection is still important for investors. Another observation to note is that despite overall low spreads, the difference between spreads of sectors can still be notable. Further, we believe the overall tight spread environment is masking differences in sector fundamentals.

(4) BofA Global Research. 2 January 2025. (5) BofA Global Research. 2 January 2025. Dispersion defined as the proportion on a face value basis of the developed market USD HY index marked +/- 100 bps outside of the overall index level.

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PPM is a US-based institutional asset manager with \$76.66 billion in assets under management as of 30 September 2024.¹ Established in Chicago in 1990, PPM exists to consistently support institutional clients in achieving their long-term value goals. We offer our

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(1) AUM includes committed but unfunded capital for PPM's private equity and commercial real estate businesses. AUM includes both securities issued by PPM CLO vehicles held by PPM separately managed account clients and the underlying collateral assets of the CLO vehicles managed by PPM.

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The **ICE BofA US High Yield Constrained Index** provides a measure of below investment grade bonds, is constructed based on the ICE BofA US High Yield Index and imposes a 2% issuer cap. The **ICE BofA 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.

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The **S&P Composite 1500** combines three indices, the S&P 500, the S&P MidCap 400 and the S&P SmallCap 600, to cover approximately 90% of US market capitalization. It is designed for investors seeking to replicate the performance of the US equity market or benchmark against a representative universe of tradable stocks.