Global Economic and Investment Outlook

Late cycle, not end cycle

Q2 2017

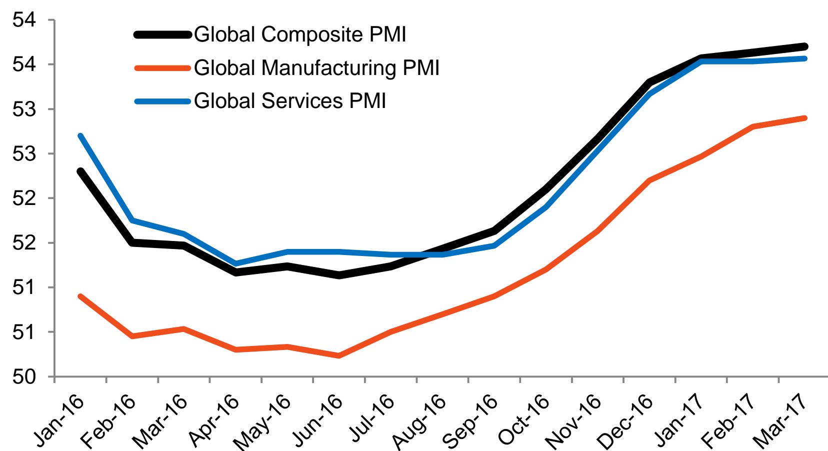
Overview: Late cycle, not end cycle

Key trends

- **"Trumphoria" fades in the new year.** Following the immediate post-presidential election exuberance, markets have started to take a more realistic view of Trump's ability to follow through on many of his campaign promises, with US bond yields and the US dollar coming under pressure.
- **Risk assets continue to push higher as the global cyclical recovery gains momentum.** Despite deflated US fiscal expectations, a strengthening and broadening of the global cyclical recovery that began late last summer has continued to support risk appetite and pushed asset values across public and private markets to the higher end of historical valuation ranges .
- **Macro fundamentals indicate the global growth and credit cycles have further to go.** However, with valuations high, volatility near all-time lows, the Fed tightening, and a plethora of political and macro risks to disrupt the current calm, investors should be prepared for a bumpier ride ahead.
- ***In this context, we continue to favour credit risk over interest rate risk with a preference for floating rate over fixed rate credit instruments and private over public markets where possible.***

After seven consecutive years of global economic expansion and most risk assets now trading at the high end of their historic valuation ranges, investors are understandably concerned that we may be nearing the end of the credit cycle. Extended periods of low volatility have historically led to the mispricing of risk and this time is unlikely to be different. However, in our view, while valuations and debt levels indicate we are in the latter stages of the cycle, underlying growth trends point to an extension of the cycle through 2017 and into 2018. Whether the cycle can be prolonged through 2018 and beyond will depend on how fiscal and monetary policy – particularly in the US – evolve over the coming months and quarters.

A synchronized cyclical recovery



Source: Bloomberg, Markit purchasing manager indexes.

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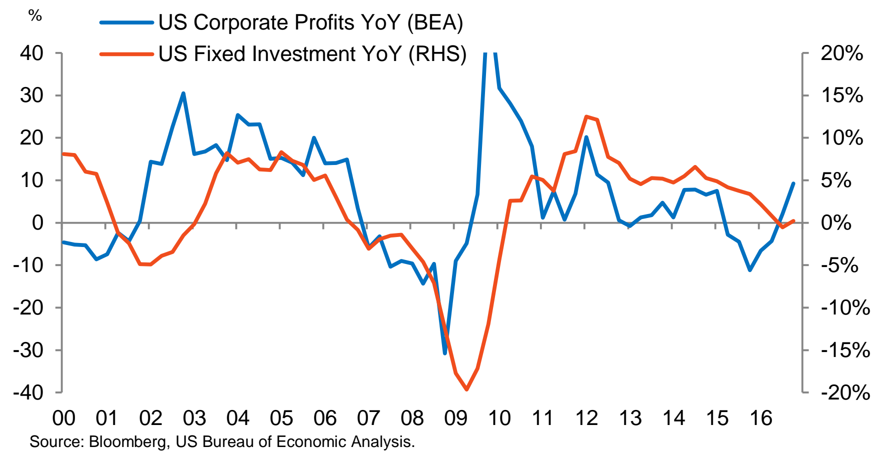
Late cycle, not end cycle: Key end of cycle risks to watch

Strong cyclical recovery, but many risks to the outlook. Cyclical indicators have continued to show healthy growth, maintaining the positive trend that began late last summer. The recovery has been broad-based, with most developed and developing economies participating in the rebound and has been the main factor driving markets higher in our view. The recovery, however, has masked a vast array of structural risks that have been building since the 2008 crisis, including large increases in government and corporate debt, high valuations across most asset classes, poor demographics and rising populist threats to post World War II political and economic frameworks.

Our base case is that positive economic growth will support an extension of the credit cycle through 2017 and into 2018. However, there are a number of risks that could short circuit the cycle. **Below we highlight some of those risks and key factors we will monitor in future editions of this report to help gauge the likelihood of an end of cycle moment.**

Tentative signs earnings and investment growth picking up



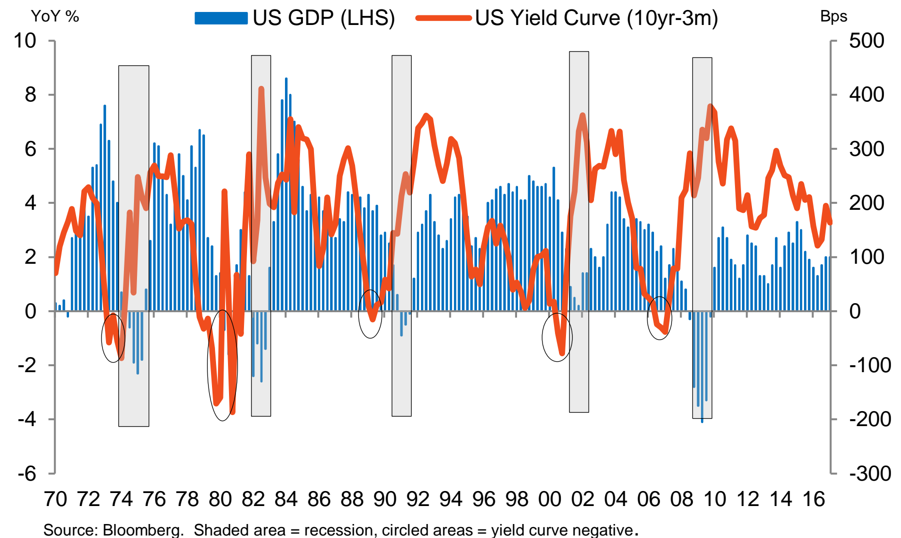
Source: Bloomberg, US Bureau of Economic Analysis.

Risk 1: The sustainability of the recovery. This is perhaps the most critical question facing investors today in our view. So far the recovery has primarily been driven by private consumption, supported by steadily improving employment conditions and low interest rates. Corporate earnings growth and private fixed investment have generally been lacklustre. While household balance sheets, employment conditions and sentiment indicators currently remain supportive, a recovery in earnings and investment growth is critical to sustaining the economic expansion and credit cycle into 2018 and beyond.

Recently there have been some tentative signs that earnings and investment may be picking up. In the US, which often leads the rest of the world, corporate profit growth turned positive in Q4 2016 for the first time since 2014. There has been a similar trend in Europe, Japan and EM. As the chart to the left shows, normally this is a positive sign for fixed investment. However, a few months does not make a trend and this is an area we will be monitoring closely over the coming months and quarters.

Risk 2: Overtightening by central banks. Historically, it has often been central banks taking away the proverbial punchbowl that has ultimately set the scene for end of cycle downturns. While the ECB and BoJ are both likely to continue to gradually reduce their bond buying programs as they hit respective bond buying capacity constraints, neither central bank is likely to start a rate rising cycle any time soon. The main risk, therefore, is the Fed. So far the Fed has been very careful and indications are most Fed members recognise the risk of overtightening as FOMC member Dudley's recent comment that "we're not removing the punchbowl yet . . . just adding a bit more fruit juice" highlights. So far core inflation has been rising at only a modest pace and we expect it to continue to do so, giving the Fed leeway to take a measured approached to rate increases. During past cycles, a sharp fall of the yield curve (usually into negative territory) has been a good lead indicator of overtightening and impending recession (see chart below).

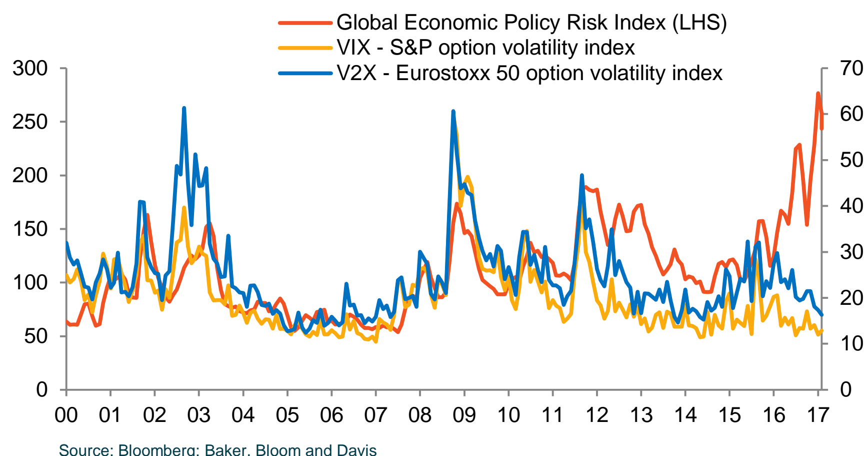
US yield curve has flattened but still substantially positive



Source: Bloomberg. Shaded area = recession, circled areas = yield curve negative.

With short rates at exceptionally low levels and direct Fed buying having distorted long yields downwards (and potentially upwards in future when the Fed's recently discussed reductions in rollovers are eventually implemented), it may be a less effective indicator now than in the past. Even with the caveats above, we think the direction and magnitude of change of the US yield curve is an indicator worth watching for early signs of building overtightening risk. Although the Fed has resumed raising rates and the curve has been flattening, near term overtightening risks appear to still be low.

Market volatility is near an all time low – but for how much longer?

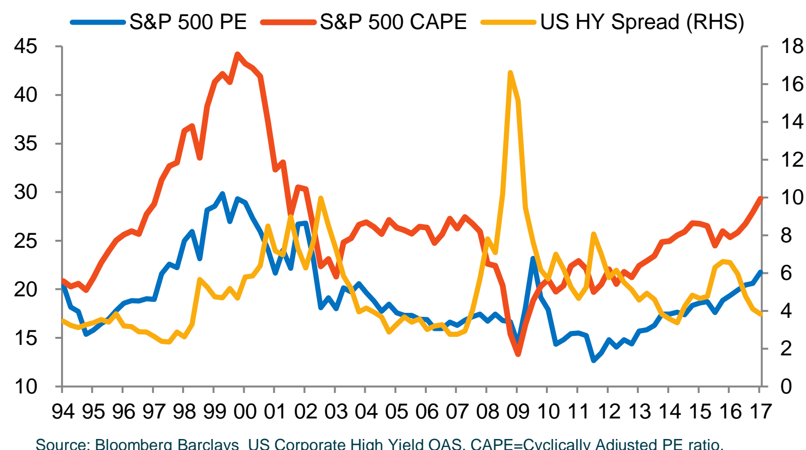


Source: Bloomberg; Baker, Bloom and Davis

Risk 3: Volatility spike and asset price correction. The most probable near term risk in our view is a spike in market volatility on the back of an unforeseen geopolitical, economic or corporate level event. As shown in the chart above, equity market volatility is currently near all-time lows. Historically, this has led to the building up of large-scale asset price mispricing. Potential triggers for corrections in volatility and valuations are multiple and by nature hard to predict. Recently added are the potential for a US government shutdown, military confrontation in North Korea and reduced foreign buying of US treasuries as local yields increase. With valuations across most asset classes currently at the higher end of historical valuation ranges, it would not take much to spark a relatively large price correction across liquid risk assets in our view. The question then is whether such a correction will mark the end of the current positive credit cycle. Normally, for asset price corrections to be the cause of economic recessions (rather than the other way around) they need to spark financial/banking crises as in 2007/08 when a crisis in the US subprime mortgage market morphed into a global crisis.

Since 2008 banks have strengthened their balance sheets and de-risked. While there are growing pockets of risks in the US (e.g. US auto loans, student loans) and Europe (Italian banks) we do not think they are currently large enough problems to spark global recession and an end to the credit cycle. China's immense corporate debt build-up continues to represent potentially the largest risk to world economic stability, but we believe this a longer-term risk that is unlikely to cause an end to the credit cycle in the near term.

Most risk assets are at high end of valuation ranges

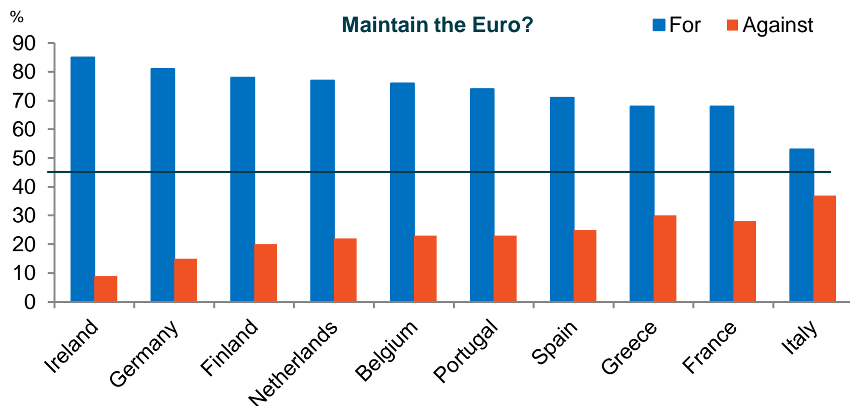


Source: Bloomberg Barclays US Corporate High Yield OAS, CAPE=Cyclically Adjusted PE ratio.

Risk 4: Europe political risk. European political risk has been increasing over the past few years. The main underlying concern is that the rise of populist anti-EU/Euro sentiment will eventually break up the EU and lead to a collapse of the Euro. In our view – certainly in the near-term – this risk remains low. The most immediate and pressing risk is the French presidential election. The fear is that nationalist candidate Marine Le Pen will win the presidency, call for a referendum on the Euro and France will vote to leave. Given the importance of France to the union, this would potentially be a death knell for the EU as we know it. There are, however, a number of large barriers to this outcome. While the 1st round is now worryingly tight, as long as mainstream candidates Macron or Fillon make it through to the 2nd round, polls indicate that either would have a commanding lead over Le Pen. Even in a worst case scenario of a Le Pen win, she would need 60% of the parliament to call a binding referendum on the EU and a majority in order to make changes to domestic policy – highly unlikely given her starting point of only two seats.

Finally, even if these two barriers are overcome, the French people would then need to vote to leave in a referendum. The most recent European Commission survey (November) shows that the majority of the French (and most Europeans) want to keep the Euro (see below). Italy is an exception, with anti-Euro sentiment nearing a majority. There are still large constitutional barriers to calling a binding EU/Euro referendum in Italy, but a weak economy, political structure and large bank and government debt burdens make it the most vulnerable country in Europe in our view and the one that merits the closest monitoring for potential crisis risk.

Most Europeans want to keep the Euro

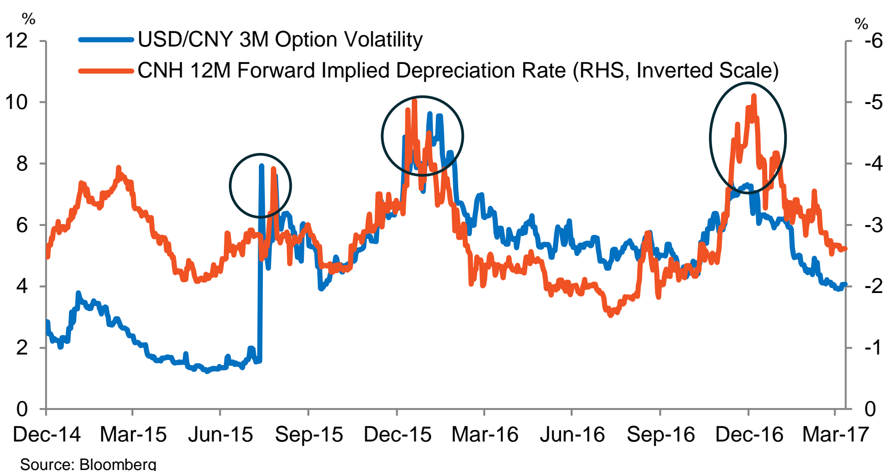


Source: European Commission, survey taken November 2016

Risk 5: Trade wars. As populist and nationalist movements have gained ground over the past year or so, the threat of trade wars has become more substantial. The UK's Brexit vote was the first shot and early indications are that UK-EU trade will suffer for it. This, however, is unlikely be sufficient to trigger a global crisis. The rise of Trump and his "America First" policies potentially pose much greater danger to the global outlook. So far it is unclear just how far Trump is prepared or will be allowed by Congress to go along the protectionist spectrum. The concern for investors is how increased protectionism might affect risks one, two and three above – either through a negative growth shock, or potentially an import price driven inflation shock that triggers central bank overtightening. A third related risk is the potential for a trade war to trigger a Chinese yuan devaluation – either because of large sentiment driven capital outflows or an explicit government policy to boost competitiveness in the face of higher trade barriers. Despite recent rhetoric, we believe trade war risk is one that will likely be well telegraphed and slow to implement so, while potentially significant in the medium to long- term, we do not see it as an imminent threat to the current cycle.

Risk 6: China financial crisis/currency devaluation. China has seen a near doubling of its debt to GDP ratio since the 2008 global financial crisis to 256% by the end of Q3 2016 (BIS). The corporate sector has been the main driver of the rise, accounting for 60% of the increase. The magnitude of the rise in such a short space of time is unprecedented and raises concerns about credit quality and the potential for corporate defaults to drive a full-blown financial crisis. While this risk is real, most evidence indicates that for now the government has the resources and tools to keep the situation sufficiently under control to avoid a crisis in the near term. Of more immediate concern is the possibility large scale capital outflows will spark accelerated Chinese yuan (CNY) depreciation or a large one-off devaluation. It was in fact this concern that caused the last two major global risk asset sell-offs in January 2016 and the summer of 2015. A key factor driving the outflows was a rapid strengthening of the US dollar (USD) that led corporates and individuals to accelerate US dollar debt repayments and send funds overseas to maintain international purchasing power. With the USD trading in a stable to weak range since January and a tightening of capital controls put in place, outflows have slowed considerably this year, substantially reducing devaluation risk for now. We believe it is a risk that may return if the USD starts to appreciate again. As illustrated below, one of the better indicators of stress in the system risk is option volatility in the CNY market. This risk has diminished recently, but it is an indicator we think needs to be monitored.

China capital outflows and devaluation risks have diminished



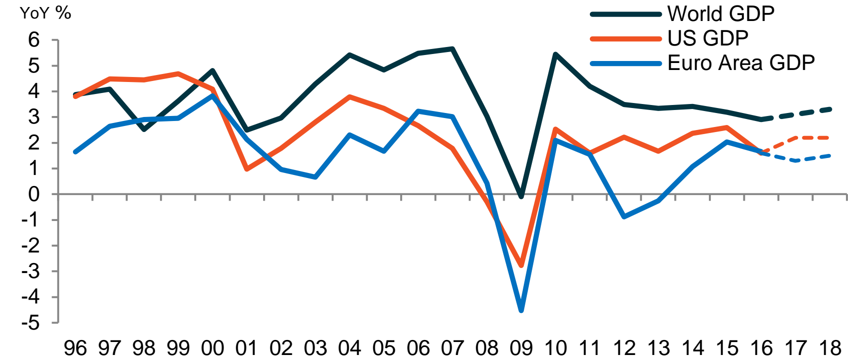
Source: Bloomberg

Summary of macro views – Recovery to continue, rates to remain low, volatility risks rising

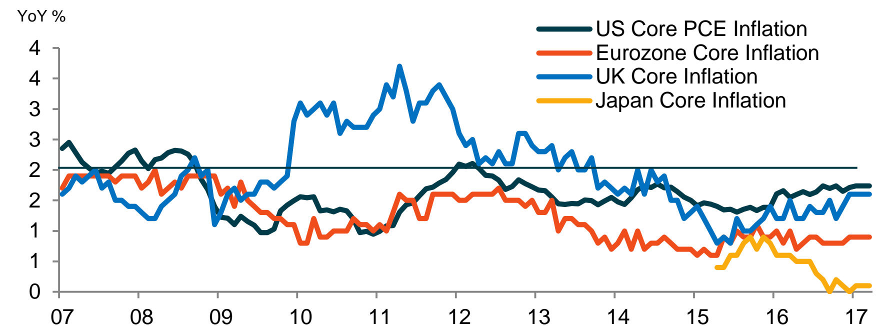
Global macro views and outlook	
Global Outlook Global growth is forecast to rise to around 3.5% in 2017 from 3.1% in 2016 on slightly faster growth in the US and EM and steady growth in Europe. ECB, BoJ, BoE to maintain easy monetary policy which will temper global bond yield rise despite 2-3 more expected Fed rate hikes this year. Rising political and policy uncertainty together with high asset valuations point to higher market volatility ahead.	
US US to remain a major engine of global growth, with full employment supporting consumption, and investment forecast to rise as capacity constraints build. Despite recent set-backs, modest fiscal stimulus likely to hit in 2018, helping to extend the business cycle. Moderate inflation rises to keep Fed in slow tightening mode and US$ firm. Policy risks are higher than usual, however, as Trump's trade and foreign policy stances may cause disruption.	
Euro Area Eurozone growth accelerated into early 2017, with private consumption supported by improving employment and low interest rates. A weak Euro and modest fiscal easing will provide further support in 2017. Political uncertainty will rise around key elections, but we expect mainstream candidates to prevail. The ECB will reduce but maintain its QE program, keeping rates low and backstopping sovereign and corporate bonds.	
UK Following Article 50 trigger in March, speculation about negotiators ability to secure continued extensive access to EU markets will remain key driver of UK markets in 2017. Growth to slow as businesses reduce investment and higher inflation reduces purchasing power. BoE expected to look through inflation and keep rates low and GBP biased to weakness.	
China China growth has stabilised around 6.5% following credit relaxation in 2016. Capital outflows have slowed on US dollar weakness and tighter capital controls reducing near-term devaluation risks. More moderate growth and further gradual FX weakness is likely in 2017, but systemic crisis risk remains low for now in our view.	
Japan Japan growth has surprised on the upside, with 2017 growth forecast to rise to 1.2% from 1.0% in 2016. BoJ to maintain accommodative stance, targeting 10yr govt yield of 0%. JPY to remain weak, except in case of a large global risk-off event.	
Asia ex-Japan The region has benefited from the rebound in the global manufacturing cycle and the wealth effect of rising markets. Inflation remains contained keeping most central banks on pause. Stable to rising growth and low rates remains investment positive.	
Australia/NZ Australia is expected to maintain steady growth of around 2.5% in 2017, as positive stimulus from FX weakness fades but is offset by a stabilisation of commodity prices. New Zealand is also expected to show solid growth of around 3% in 2017.	

Legend: Arrow direction represents economic growth trend. Colour represents growth relative to respective developed or emerging market average growth rate as per IMF WEO. Green=above average, Amber=in-line, Red=below. Global, relative to own 2 year average.

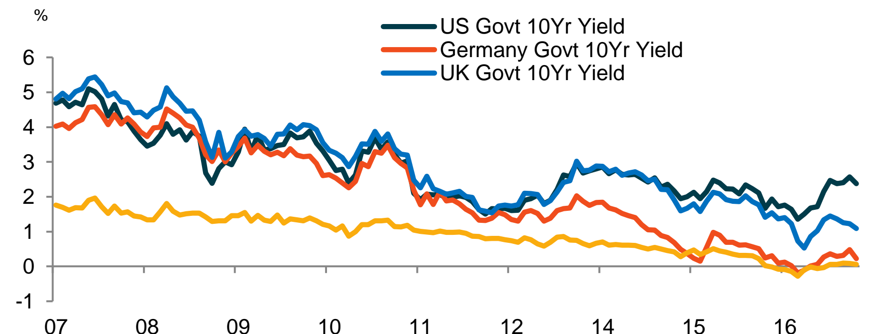
Slow but steady global growth ahead



Core inflation remains subdued



Bond yields bottomed in 2016, but expected to stay low



Source: IMF, Bloomberg consensus forecasts as of March 2017

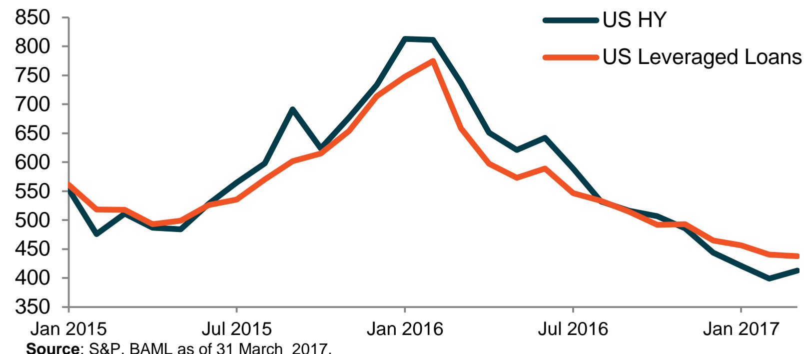
Market views – Strong credit fundamentals continue to support returns

Asset Class		Market Views and Outlook
US	High Yield Bonds	Strong returns continue, up 17% over 12 months despite the sharp oil price fall in March. In Q1 investors switched from bonds into loans, though the trend has moderated recently. While fundamentals and default trends remain supportive, HY's sensitivity to higher rates and market volatility leads us remain biased towards loans.
	Leveraged Loans	Loans also showed positive returns, extending 12 month gains to 9.7%. Technicals remain positive, with demand outstripping net new supply on higher rates and CLO formation. Given their defensiveness in the face of rising rates and still sound fundamentals, we prefer loans over HY.
	Private Debt	The market remains well supported with dry powder holding near all time highs and company fundamentals still positive. Strong demand continues to push pricing tighter, increasing the importance of deal selectivity and structuring.
Europe	High Yield Bonds	European HY bonds are up 10% over the past 12 months and are expected to continue to benefit from accommodative ECB policy, low default rates, rising growth and investors' search for yield.
	Leveraged Loans	Loans had a positive start to 2017 bringing 12 month returns to 6.4%. After a major lack of supply in 2016, supply rebounded in Q1, with refinancing the main driver. Defaults fell to 1.7% in Q1 and we anticipate strong company fundamentals will drive positive returns in 2017.
	Private Debt	Dry power has continued to rise keeping deal demand strong and further increasing the premium on being selective in deal choice and structuring. Positive underlying growth and fundamentals point to continued healthy returns in 2017.

USD and EUR high yield total returns[1]

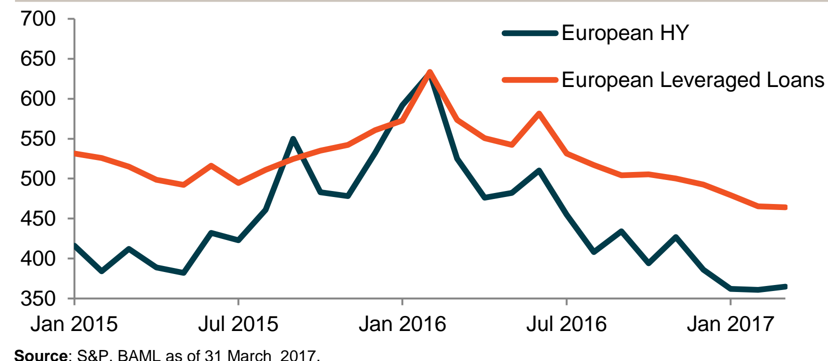
US	Q1 2017	LTM[2]	3 years (annualised)	5 years (annualised)
HY	2.7%	17.4%	4.5%	6.6%
Loans	1.1%	9.7%	3.6%	4.6%
Europe	**Q1 2017**	**LTM**	**3 years (annualised)**	**5 years (annualised)**
HY	1.8%	10.0%	5.3%	7.9%
Loans	1.2%	6.4%	4.7%	5.7%

USD high yield bond and leveraged loan market spreads[1]



Source: S&P, BAML as of 31 March 2017.

EUR high yield bond and leveraged loan market spreads[1]



Source: S&P, BAML as of 31 March 2017.

1. Data as of 31 Mar 2017, asset classes represented by the following indices: BAML HCNF (US HY) S&P LLI (US Leveraged Loans), BAML HPID (EUR HY), S&P ELLI (EUR Leveraged Loans). Further details and definitions of the indices are provided in the index disclaimer in the notes section. [2]LTM = Last twelve months.

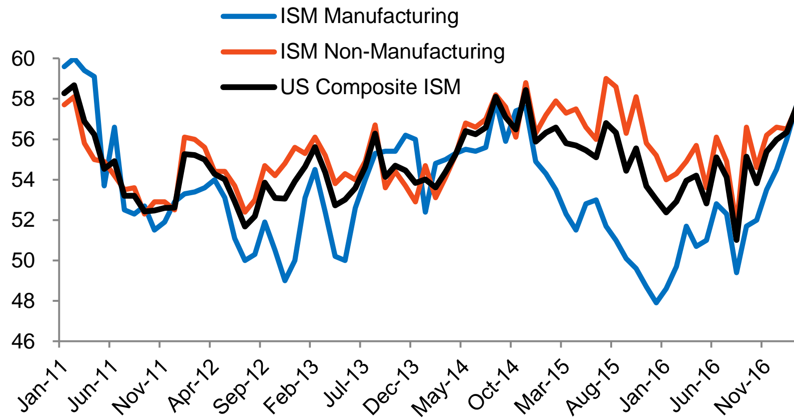
Macro views

- US – Post-election exuberance fades but cyclical recovery continues
- Europe – Positive growth surprises offset political risks
- UK – Growth remains healthy but some early signs of weakness
- China – FX risk declines for now, manufacturing rebounds

US – Post-election exuberance fades, but cyclical recovery continues

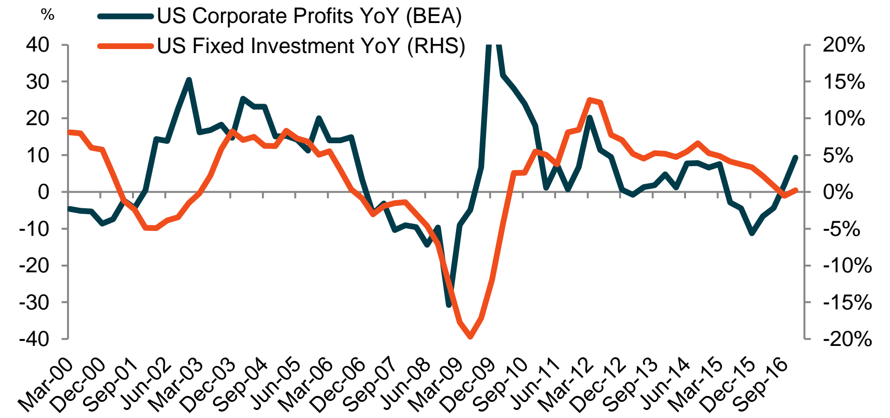
- **US cyclical indicators continued to rise in Q1, maintaining the uptrend that began last summer.** US PMIs have accelerated in the first two months of 2017, retail sales are growing at their highest pace in four years. 4Q GDP was revised up to 2.1% and the Fed is forecasting growth of 2.2% this year.
- **There are tentative signs that earnings and investment growth are picking up.** The gains are modest, but if confirmed, will add a welcome support to what has so far been primarily a consumer-led economic recovery.
- **Inflation rising, but core inflation under control.** Headline inflation has increased on higher energy and food prices. Core PCE, which excludes food and energy, however, has stayed below the Fed's 2% target. While it is likely to rise further, it is unlikely to rise sufficiently to cause an acceleration of Fed rate hikes.
- **Fed increases target rate in March as expected, forecasts two more this year.** The 10yr bond yield declined and yield curve flattened as Trump's failure to pass his health bill raised concerns about his ability to implement his stimulus program and investors question the longer term sustainability of the recovery.

US purchasing manager surveys point to steady growth ahead



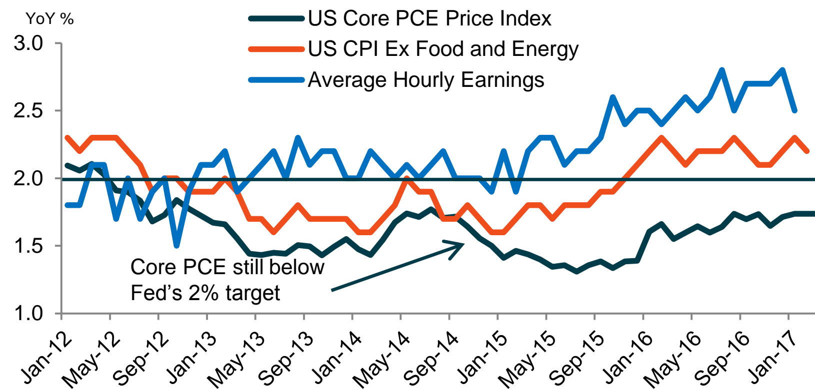
Source: Bloomberg

Tentative signs company earnings and fixed investment picking up



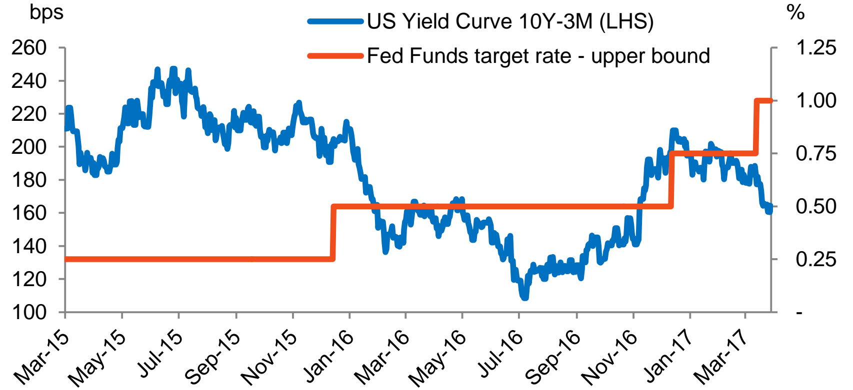
Source: Bloomberg

Core inflation rising as labour market tightens, but at a modest pace



Source: Bloomberg

As Fed has hiked rates the yield curve has flattened

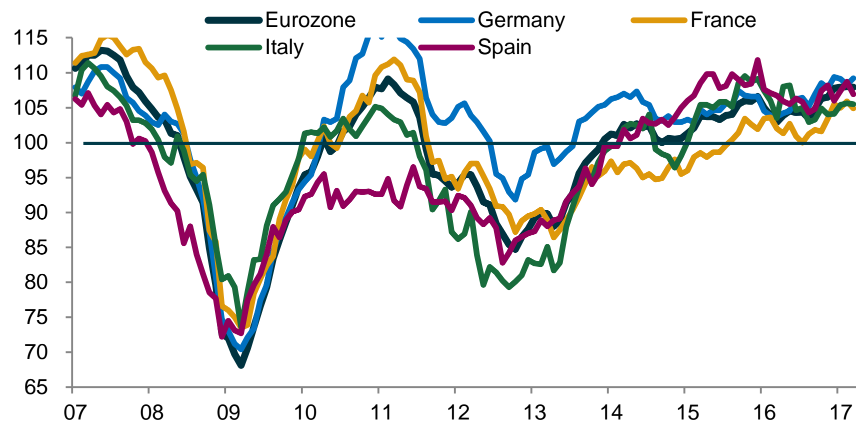


Source: Bloomberg

Europe – Positive growth surprises offset political risks

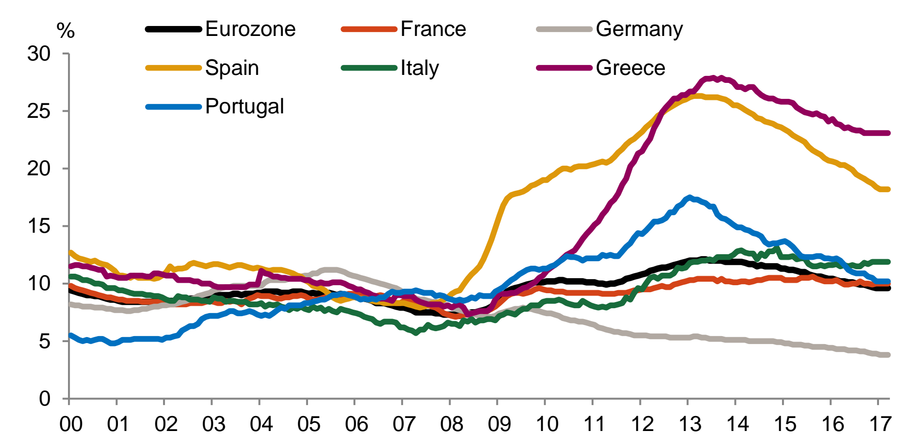
- **Eurozone economic growth and earnings surprise on the upside in early 2017.** Continued ECB bond buying, low rates, a weak currency , modest fiscal expansion and improving employment are expected to support growth of around 1.6% in 2017.
- **Political risk may increase uncertainty and market volatility in 2017** but is unlikely to be sufficient to derail growth this year. Italy is the biggest medium term risk in our view, with Euroscepticism near nearing a majority view and elections due to be held by May 2018 latest.
- **Headline CPI remains distorted upwards by higher oil prices and weaker Euro**, but spare capacity and weak growth should keep CPI below the ECB's 2% target.
- **The ECB is expected to continue to focus on supporting growth and financial stability.** The QE program is likely to extend into 2018, though bond purchases will likely be reduced in 2018 as the ECB increasingly comes up against ownership limits. While this may have an impact on peripheral yields (Italy in particular), we expect policy rates will remain low and growth supportive for the foreseeable future.

Synchronised recovery across most of Europe



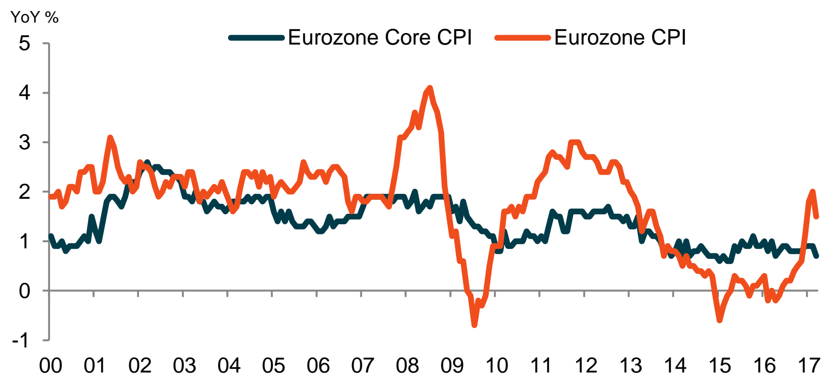
Source: Bloomberg. European Commission Economic Sentiment Index data to March 2017.

Unemployment is falling, but still too high in many countries



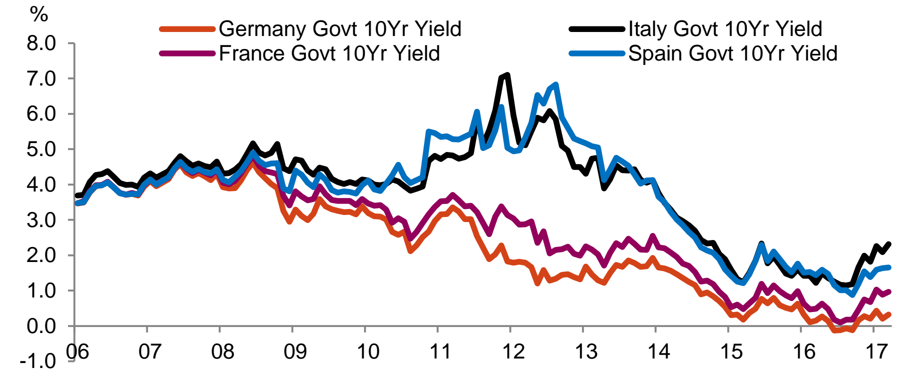
Source: Bloomberg.

Headline inflation is up, core inflation remains contained



Source: Bloomberg.

Easy ECB policy continues to anchor Euro rates at low levels



Source: Bloomberg

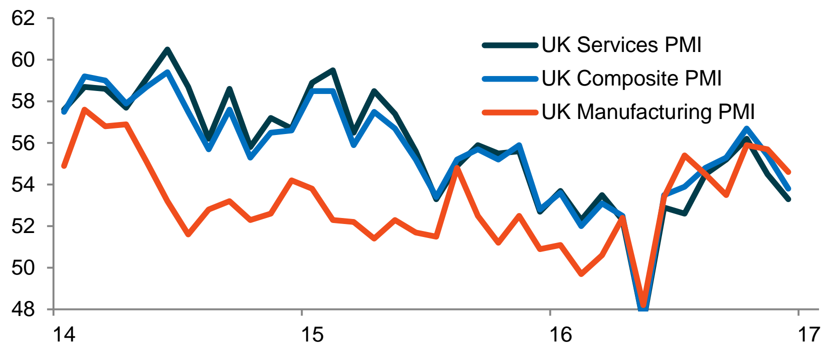
UK – Growth remains healthy but some early signs of weakness

- **Lead indicators remain well above their post-Brexit vote lows.** However, recent economic releases such as retail sales and purchasing manager indices point to some weakening in early 2017.
- **Inflation continues to rise, potentially acting as a drag on consumption and investment.** Real income growth has been squeezed since early 2016 and headline inflation is now rising faster than wages (see chart below).
- **While growth is forecast to moderate, the slowdown is expected to be gradual**, with consensus forecasting only a moderate slowing of growth from 1.8% in 2016 to 1.7% and 1.3% in 2017 and 2018 respectively.

Uncertainty surrounding Brexit negotiation outcomes puts quite a large potential margin of error around these forecasts of course.

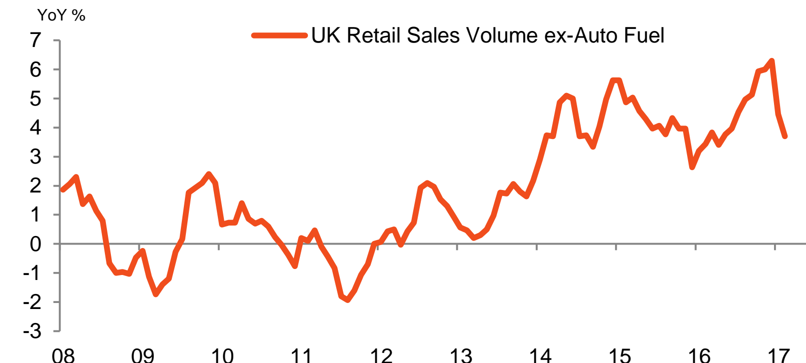
- **The BoE has become modestly more hawkish but we do not expect a rate hike any time soon.** The spike in import prices has been the main factor behind the recent rise in inflation and this is likely to start to dissipate later this year as base effects kick in. This is likely to coincide with slower economic growth, keeping the BoE in check.
- **The worst of the pound decline may be behind us but a weakening bias seems likely** given continued Brexit negotiation uncertainty, slowing growth and a still large current account deficit.

UK purchasing manager surveys showing some weakness



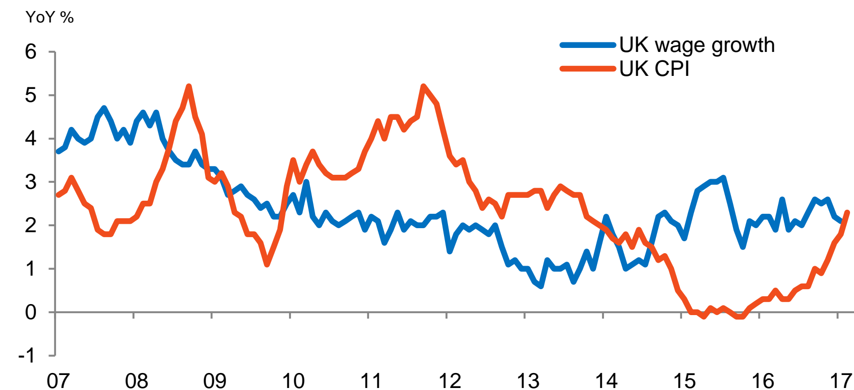
Source: Bloomberg

Retail sales still strong but have slowed in the new year



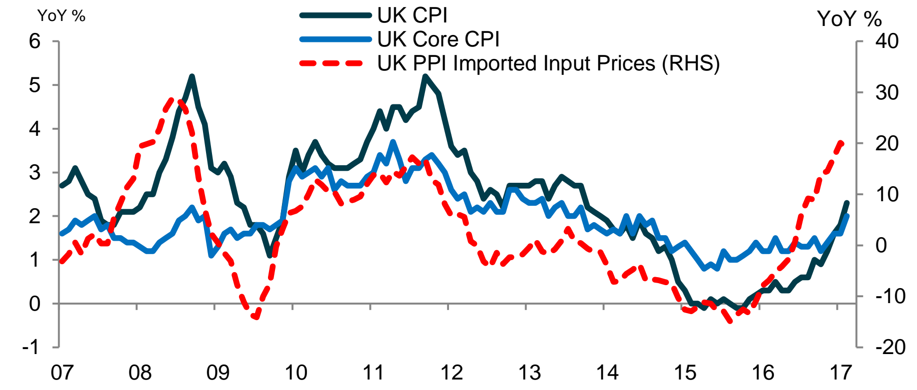
Source: Bloomberg

Real income growth slowing as inflation picks up



Source: Bloomberg

The sharp GBP decline is pushing up both headline and core CPI

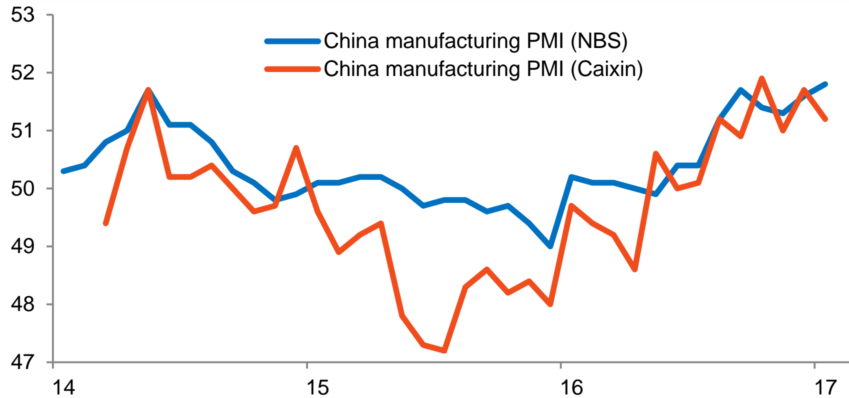


Source: Bloomberg

China – FX risk declines for now, manufacturing rebounds

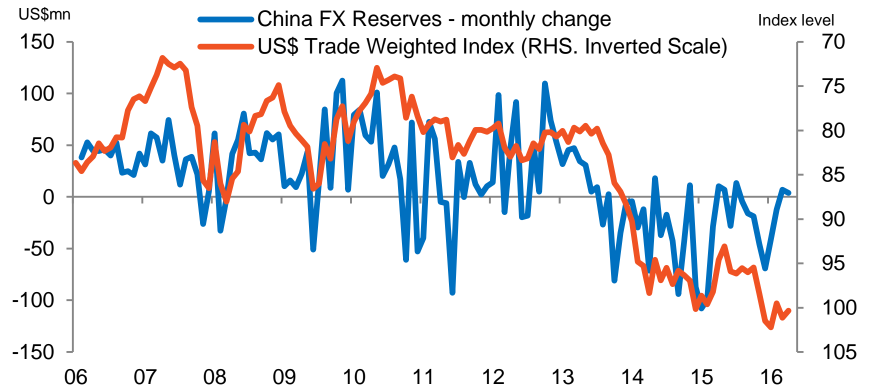
- **China capital outflows have stabilised on tighter capital controls and a reversal of US dollar strength so far this year.** FX reserves actually increased in Feb and March, highlighting that China FX depreciation pressures have abated for now. The reduced perceived risk has been reflected in a sharp fall in FX option volatility.
- **Devaluation risk has abated for now.** However, if US dollar strength resumes, capital outflow pressures will likely return.
- **China manufacturing growth rebounds as global industrial cycle turns up.** China is benefiting from the global industrial recovery that began late last summer. However, concerns about real estate bubbles in tier 1 and 2 cities and growing corporate debt burdens have led to new tightening measures that will likely temper growth this year.
- **More moderate growth of around 6.5% and further FX weakness is likely in 2017,** but systemic financial/debt crisis risk remains low in our view.

China manufacturing sector rebounding, following the global trend



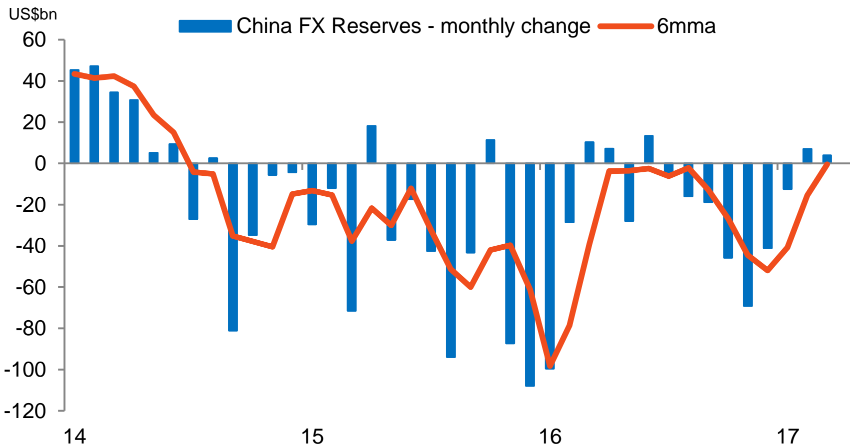
Source: Bloomberg

Stable US dollar has helped slow capital outflows



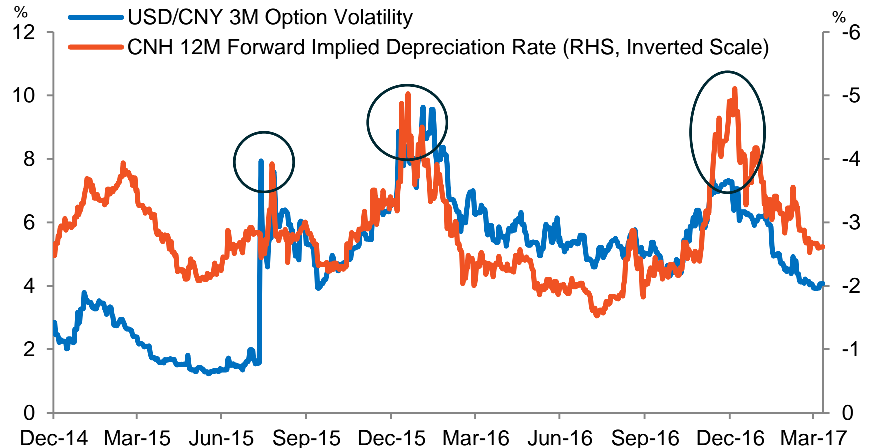
Source: Bloomberg

China FX reserves have started to rise again



Source: Bloomberg

China FX risk has moderated but needs to be monitored



Source: Bloomberg

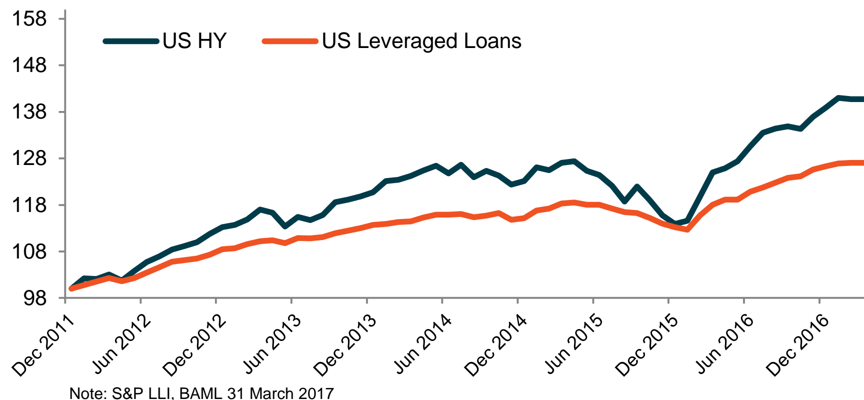
Market views

- **US high yield markets** – Investors switch from high yield debt into loans
- **US private debt** - Strong demand puts premium on selectivity and structuring
- **European high yield markets** – Fundamentals override political noise
- **Europe private debt** - Structural tailwinds remain strong

US high yield markets – Investors move out of high yield debt into loans

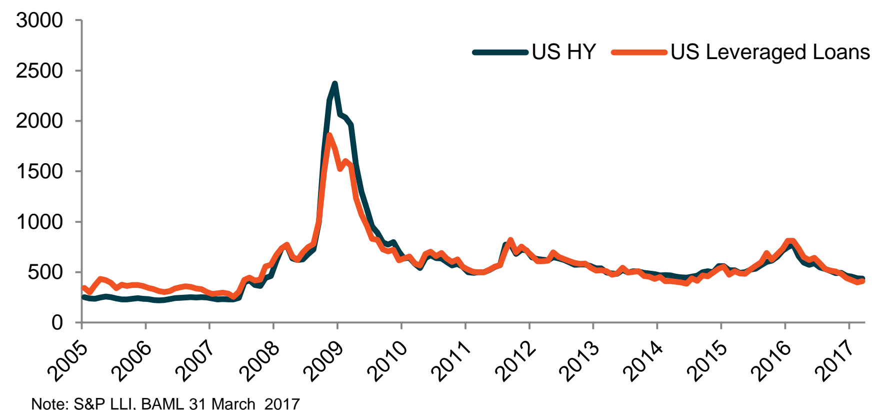
- **US high yield markets continued to perform well in Q1,** with high yield bond returns up 2.7%[1] despite the sharp oil price fall in March, extending their 12 month gains to 17.4%. Leveraged loans showed smaller, but still positive returns of 1.1%[2] in Q1, extending their winning streak to 13 months for 12 month gains of 9.7%.
- **Cyclical data and oil price remain the main performance drivers.** In the first two months of the year "Trumphoria", strong cyclical data and a stable oil price helped push returns higher. March saw a break in this trend as investors began to question Trump policy follow-through and the oil price fell. Stability has returned in early Q2.
- **Leveraged loans saw their largest ever quarterly supply in Q1,** up $203bn[1] . However, most supply was re-financing as borrowers took advantage of falling yields and strong demand to lock in tighter pricing. HY supply rose $81bn[2] in Q1.
- **A key theme during the quarter was a switch from high yield bonds into loans,** with net outflows of $5.9bn[3] from HY and $11.4bn into loans as investors anticipated higher rates and the oil price fell. This trend has moderated more recently.
- **Default rates low and falling.** While leverage has increased, company fundamentals appear sound, with loan defaults stable at 1.5% LTM[1] and HY defaults falling to 5.4% in Feb[4]. As long as US growth and the oil price stays firm we expect this trend to continue.

Continued healthy returns for high yield debt and leveraged loans



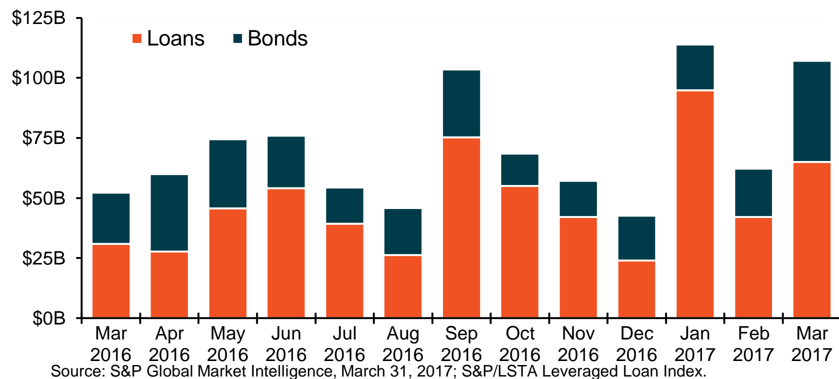
Note: S&P LLI, BAML 31 March 2017

Spreads tighten even as rates rise



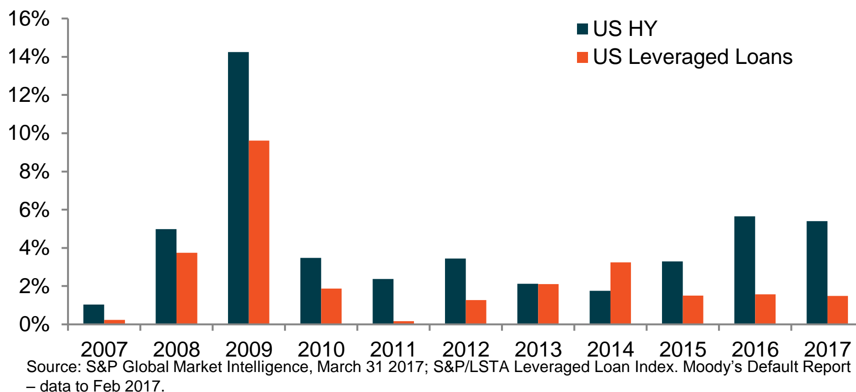
Note: S&P LLI, BAML 31 March 2017

Record breaking leveraged loan issuance driven by re-financing



Source: S&P Global Market Intelligence, March 31, 2017; S&P/LSTA Leveraged Loan Index.

Defaults expected to fall further as US growth remains firm



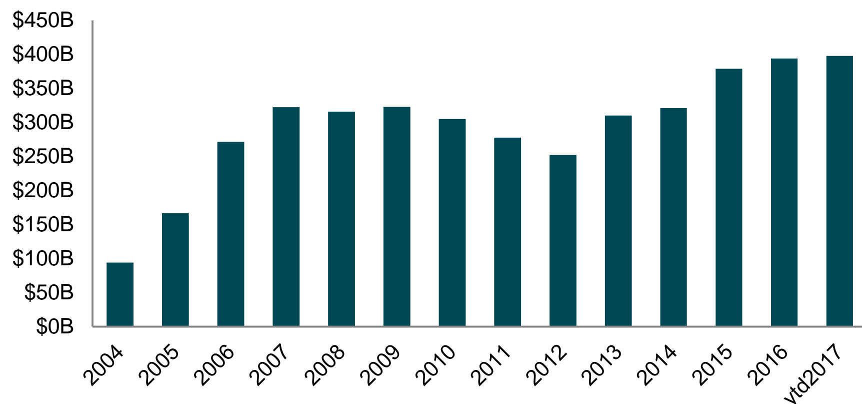
Source: S&P Global Market Intelligence, March 31 2017; S&P/LSTA Leveraged Loan Index. Moody's Default Report – data to Feb 2017.

1. Source: BAML HCNF and S&P LLI. Data as at 31 Mar 2017, please see further detail and definitions of the indices in the index disclaimer in the Notes section. 2.S&P LCD. 3. Barclays, Lipper. 4. Moody's estimates.

US private debt – Strong demand puts premium on selectivity

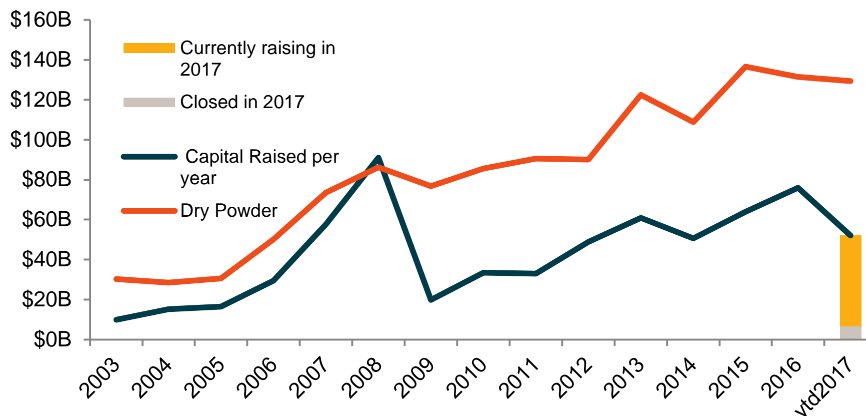
- **US private debt remains well supported,** with private debt and private equity dry powder near all-time highs, default rates low and company fundamentals benefiting from an extended US business expansion.
- **Private debt capital raising remained high in Q1 2017**, with distressed and direct lending funds leading the way. In the first three months of 2017, distressed funds made up around 40% of fund raising, followed by direct lending at around 30% and special situations and mezzanine making up most of the rest.
- **Strong deal demand has kept purchase prices high by historic standards.** Large deal LBO purchase multiples remain near 10x EBITDA, with average leverage increasing to 5.6X in Q1 2017, putting a larger than usual premium on deal selectivity and structuring.
- **Stable cash interest cover, but decreasing spread per unit of leverage.** EBITDA/Cash interest payments continues to hold at comfortable levels. Spreads relative to gearing have declined but remain above pre-crisis levels.

Private equity dry powder remains at historical high in Q1 2017



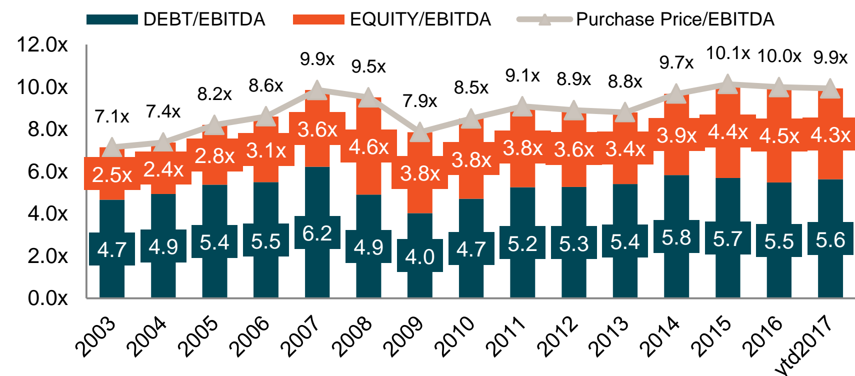
Note: Preqin; Dry powder for private equity buyout funds and distressed PE as of March 2017.

US private debt fund raising on the rise



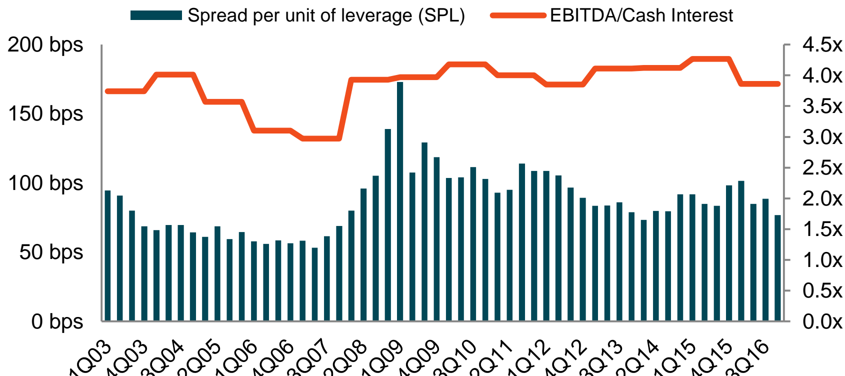
Note: Preqin, capital raised and dry powder for direct lending, mezzanine, distressed debt& special situations funds.

LBO purchase prices and leverage continue to increase



Note: S&P as of 1Q 2017, EBITDA of €/$ 50M or more.

Spread per unit of leverage is has declined, but interest cover still strong

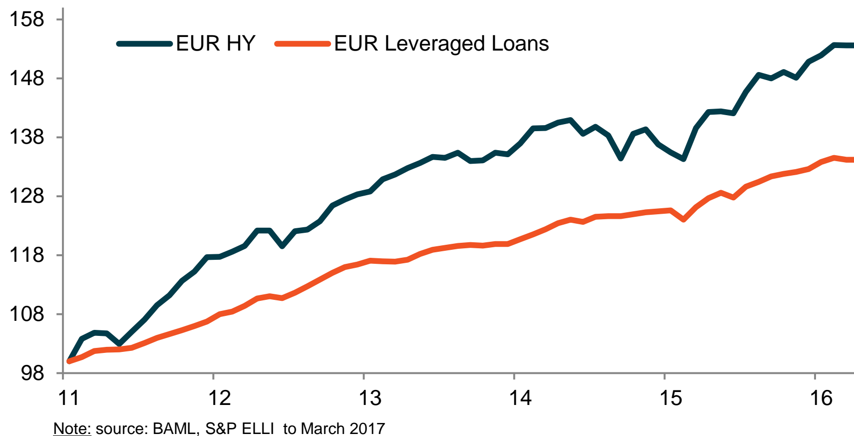


Note: S&P as of 1Q 2107, EBITDA of €/$ 50M or more.

European high yield markets – Fundamentals override political noise

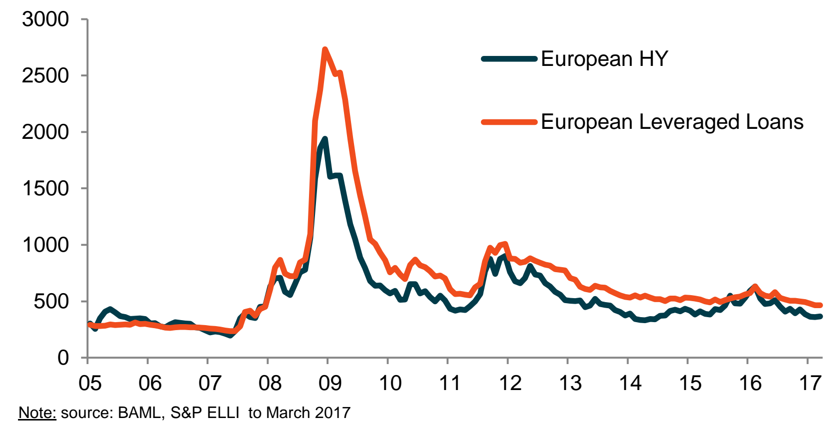
- **European high yield markets have a healthy start to 2017.** High yield and leveraged loans continue their positive performance into 2017, rising 1.8%[1] and 1.2%[1] in Q1 respectively. This follows on returns of 10.3% and 5.7% for full year 2016.
- **A positive growth, low rate environment overrides political noise in Q1.** The first few months of the year have been characterised by low market volatility and positive returns despite headline political noise. While negative political surprises are still a real risk (though low in our view), we believe continued bond buying and easy policy by the ECB together with continued positive economic growth will remain market supportive.
- **Strong supply pipeline, dominated by refinancing.** Leveraged loans saw €34bn of new supply in Q1, while high yield saw €23bn of new supply, the combined largest new issuance since Q2 2014. As in the US, the vast majority was refinancing as borrowers locked in cheaper funding. There has also been a trend for bonds to be taken out with loans, as borrowers look for greater flexibility in terms of call protection.
- **Default rates remain low and are expected to fall further.** In February Europe's high yield default rate fell to 2.2%, down from a 3% avg last year with Moody's expecting it to fall further by year end. Leveraged loan defaults fell to 1.7% in Q1 from 2.4% last year.

Continued positive returns



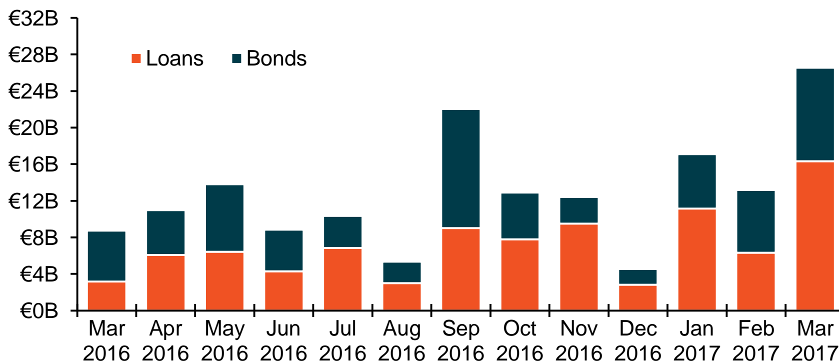
Note: source: BAML, S&P ELLI to March 2017

Spreads continue to tighten, though still wider than pre-crisis levels



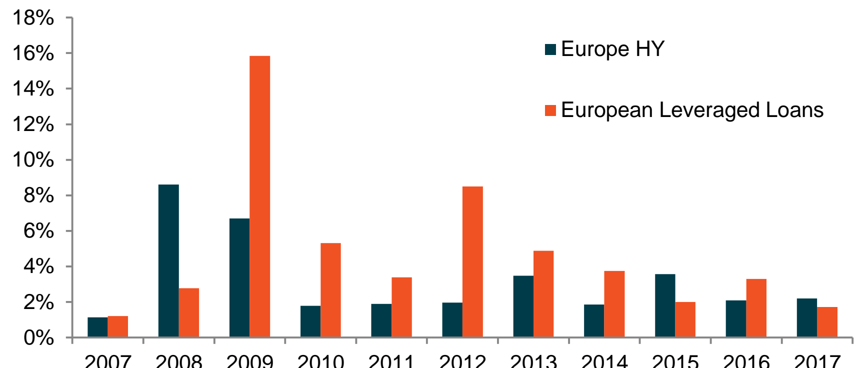
Note: source: BAML, S&P ELLI to March 2017

Strong new issuance with refinancing dominating



Note: Source: S&P Global Market Intelligence, March 2017; S&P/LSTA Leveraged Loan Index.

Default rates still low and falling



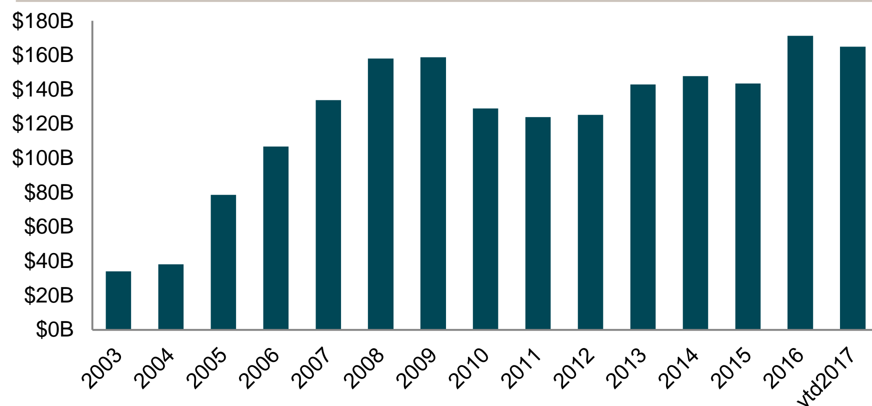
Note: Source: S&P Global Market Intelligence, March 31 2017; S&P/LSTA Leveraged Loan Index. Moody's Default Report – data to Feb 2017.

Note: 1. Source: BAML HCNF and S&P LLI. Data as at 31 March 2017, please further detail and definition of the indices are provided in the index disclaimer in the Notes section. 2.S&P LCD.

Europe private debt – Structural tailwinds remain strong

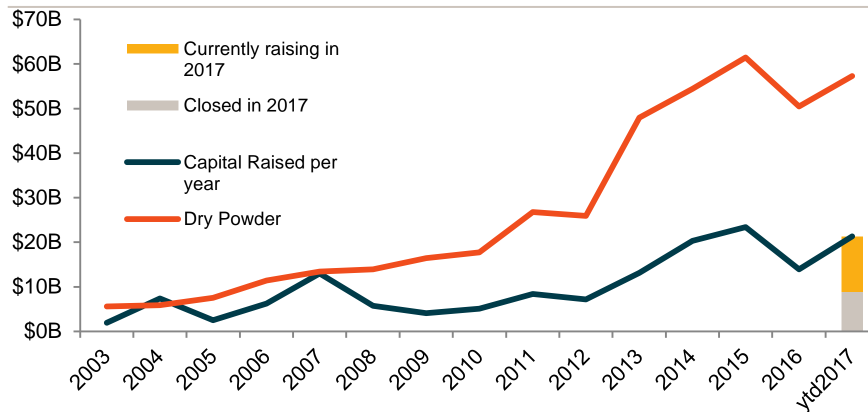
- **PE dry powder dipped slightly in Q1 2017, but remains high by historic standards.** Large amounts of dry powder are expected to continue to provide a structural tailwind to deal flow and demand for private debt financing.
- **Private debt funds raised and dry powder rebounded strongly in Q1 2017** as investor demand for yield and strong historic returns attracted investors to the asset class. Direct lending funds accounted for the largest amount of capital raised and dry powder in Q1, continuing the trend that started in 2016.
- **While leverage has increased at the larger bank-dominated syndicated end of the market, bilateral direct private lending and sponsorless niche mezz have managed to maintain tighter discipline.** These deals have seen a less pronounced increase in leverage and generally retain better pricing than larger LBO deals.
- **Underlying company fundamentals remain positive**, with default rates low, interest cover still high, better economic growth and continued low interest rates supporting company fundamentals.

Europe private equity dry powder down slightly but remains sizeable



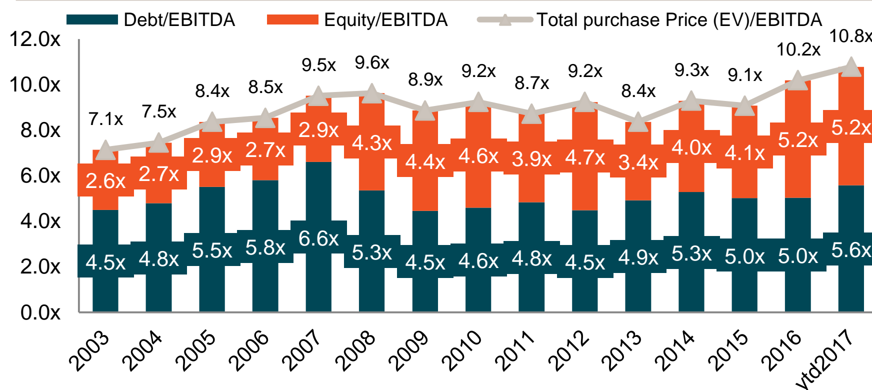
Note: Preqin; dry powder for private equity buyout funds and distressed PE as of March 2017.

Europe private debt dry powder has rebounded



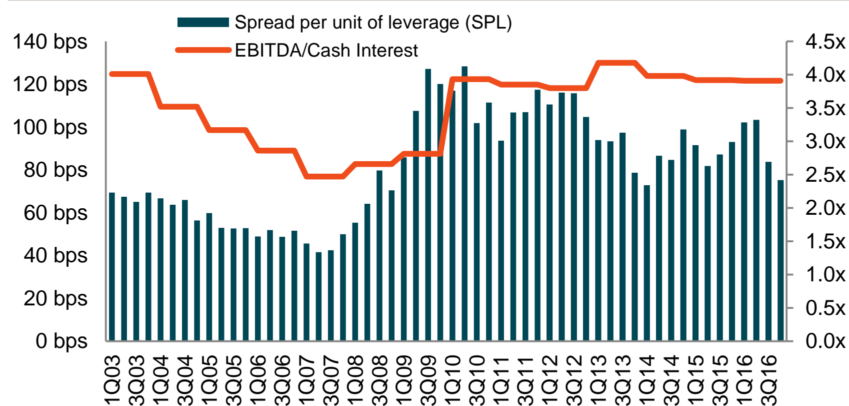
Note: Preqin, capital raised and dry powder for direct lending, mezzanine, distressed debt& special situations funds

Large LBO leverage rising, niche bilateral deals retain better terms



Note: S&P as of 1Q 2017, EBITDA of €/$ 50M or more.

Spread per unit of leverage is down, but interest cover still strong



Note: S&P as of 1Q 2017, EBITDA of €/$ 50M or more

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APPENDIX

US and Europe High Yield Performance Table

US and EUR total returns[1]

US	Mar 2017	Q1 2017	LTM	3 years (annualised)	5 years (annualised)
HY	-0.2%	2.7%	17.4%	4.5%	6.6%
Loans	0.1%	1.1%	9.7%	3.6%	4.6%
Europe	**Mar 2017**	**Q1 2017**	**LTM**	**3 years (annualised)**	**5 years (annualised)**
HY	-0.1%	1.8%	10.0%	5.3%	7.9%
Loans	-0.2%	1.2%	6.4%	4.7%	5.7%

US and EUR Change in Spreads

US	Mar 2017	-1 month	-3 months	-6 months	- 12 months
HY	413bps	14bps	-31bps	-229bps	-324bps
Loans	438bps	-3bps	-27bps	-151bps	-221bps
Europe	**Mar 2017**	**-1 month**	**-3 months**	**-6 months**	**- 12 months**
HY	365bps	4bps	-21bps	-145bps	-160bps
Loans	464bps	-1bps	-29bps	-117bps	-109bps

US and EUR Absolute Yields Levels

US	Mar 2017	-1 month	-3 months	-6 months	- 12 months
HY	5.9%	5.7%	6.2%	7.5%	8.6%
Loans	5.0%	5.0%	5.2%	6.0%	6.5%
Europe	**Mar 2017**	**-1 month**	**-3 months**	**-6 months**	**- 12 months**
HY	3.3%	3.1%	3.5%	4.8%	5.3%
Loans	4.2%	4.3%	4.5%	5.2%	5.1%

Please note:
1. Data as of 31 March 2016, please further detail and definition of the indices are provided in the index disclaimer in the Notes section.

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