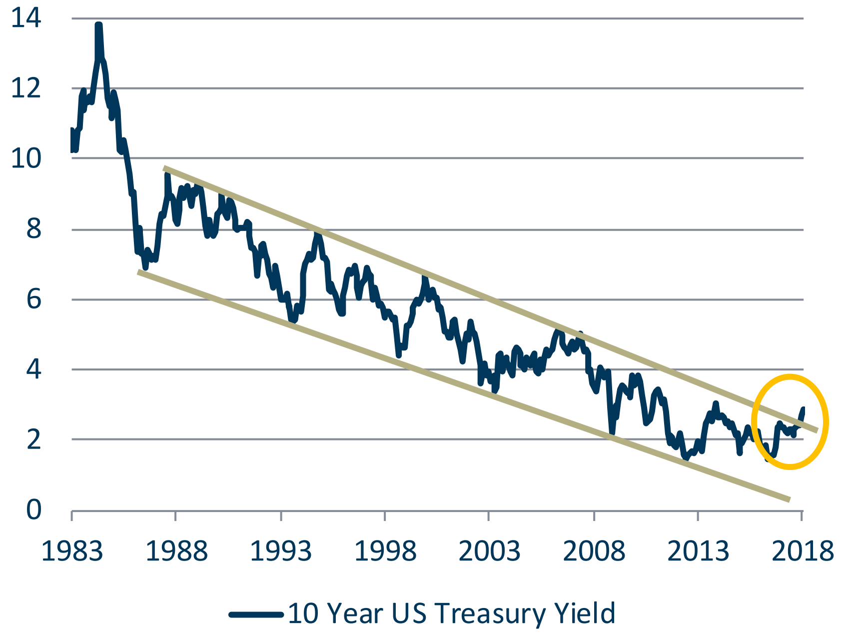
Bernd Hartmann · Head of Group Investment Research, Chief Strategist · 8 March 2018

The underestimated threat of rising yields and how to cope with it

VP BANK

Are we already in the middle of a regime change?

The end of the 30-year lasting bond bull market?

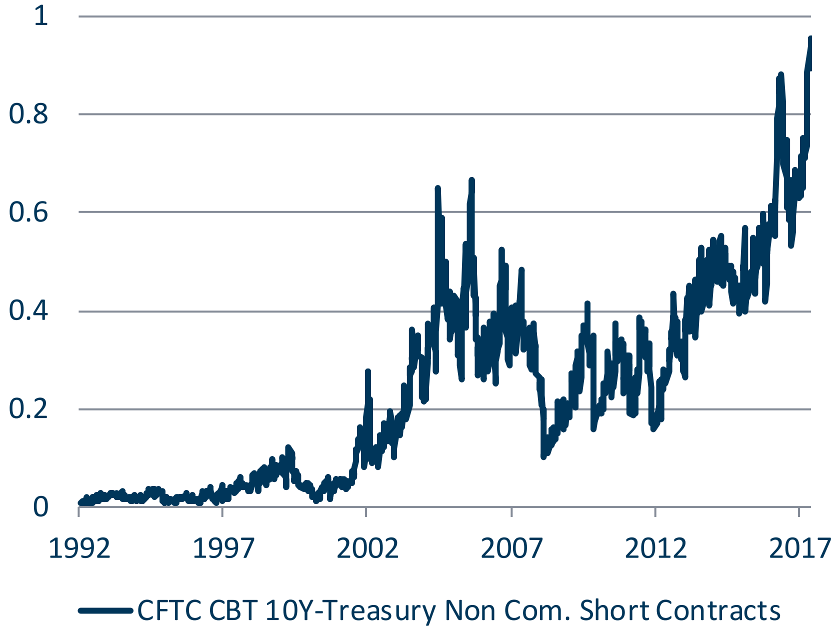


- Falling yields and low rates have been a main driver for stock markets.
- Thanks to the loose monetary policy and the absence of inflation, good macroeconomic data didn't affect higher yields.
- This has changed in January. After initially ignoring the re-pricing of interest rate expectations, stock markets reacted quite negatively in February.
- Risk of too good data: Good macroeconomic data can now be accompanied by rising rate expectations. Good data no longer has to be good news for the equity markets as well.
- Are we already there? That would be a major game changer…

Source: VP Bank, Bloomberg

Good reasons to believe we are not there, but…

Biggest short positions in the history of bonds

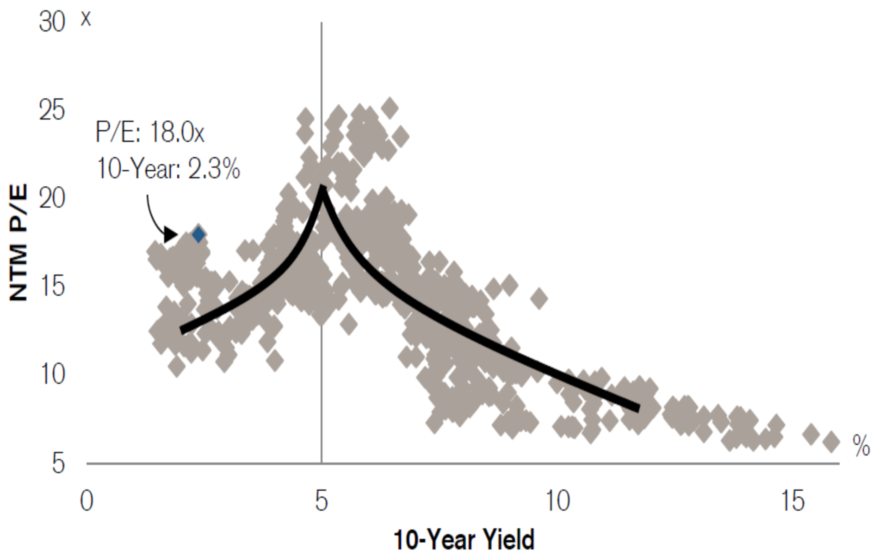


- Currently, the major driver behind rates is inflation. Although there is some cyclical pressure from the labour market on inflation in the US, structural forces like globalisation, demographics and digitalisation weigh on yields.
- Therefore, US core inflation will pick up, but to a limited extent. This should limit the upside for now.
- But with extra fiscal stimulus from the US, already higher growth rates and a growing twin deficit could increase the risk of rising yields.
- Record high short positions in treasuries do signal that nothing should go wrong.

Source: VP Bank, Bloomberg

The crux of bond yields

Ambivalent relationship bond and equity market

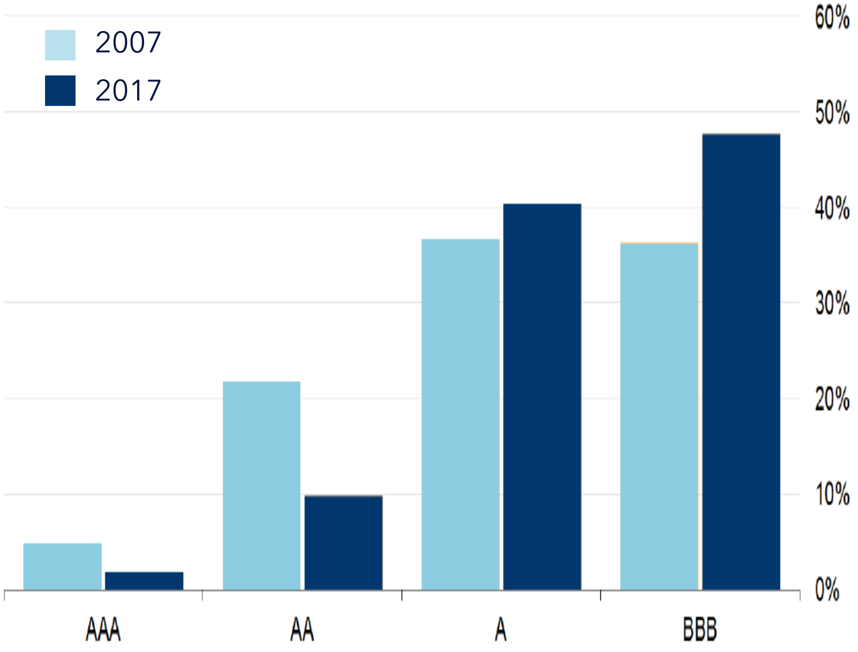


- Yields are key for financial markets, as they not only affect the bond market.
- Yields act as an indicator for the attractiveness of all asset classes and therefore influence the entire portfolio. E.g. low yields have been a major driver for equity markets.
- However, history indicates that the relationship is ambivalent. After reaching a certain level, rising yields are a burden for equities.
- The big question is: where is the tipping-point today? Of course lower, but where?
- Risk premiums still favour equities over bonds. But the major threat is that higher yields cause a re-evaluation of corporate bonds and equities.

Source: Standard & Poor's, Federal Reserve, Thomson Financial, Credit Suisse - 1965 to present

Creeping increase of risks within the bond market

Deterioration in USD IG Corp. Ratings



- Loose monetary policy causes distortions, especially in the bond market.
- Credit quality has gradually deteriorated:
  - The incentive for a higher credit rating has vanished. Companies are leveraging up.
  - Companies are taking advantage of the low interest environment and increased long term borrowing.
- Investors following or investing into an index are witnessing an increased interest rate sensitivity and a worse credit quality.

Source: VP Bank, Bloomberg

Do’s and Don'ts when yields are rising

What to do:

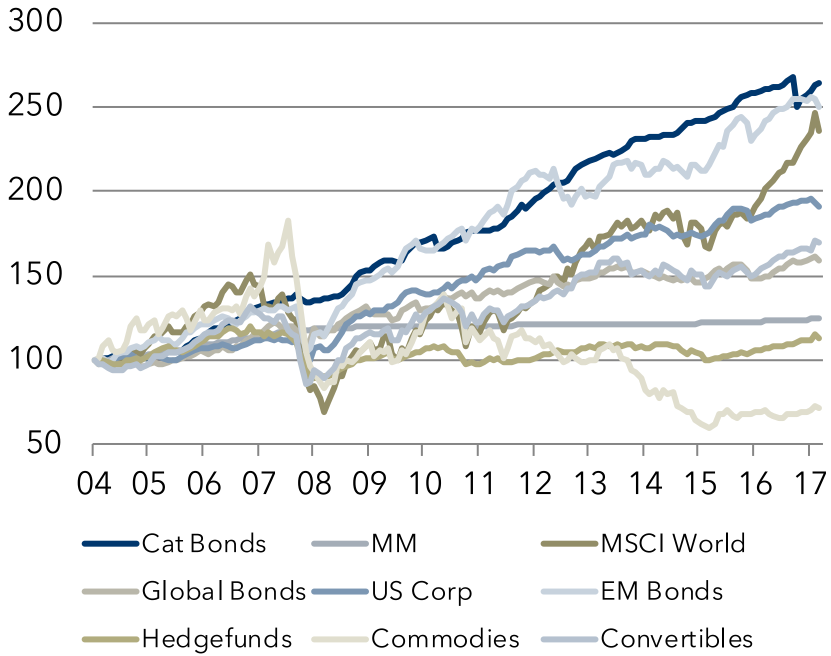
- TIPS
- Focus on single bond selection
- Quality stocks
- Hedge funds-like strategies
- Low or uncorrelated asset classes
- Floating rate notes
- Undistorted and under-represented asset classes: Private Debt

What not to do:

- Long duration
- Poor credit qualities
- Bond proxies: highly leveraged, rate sensitive stocks

Favour uncorrelated investments: Insurance linked securities

Cat bonds vs. other asset classes

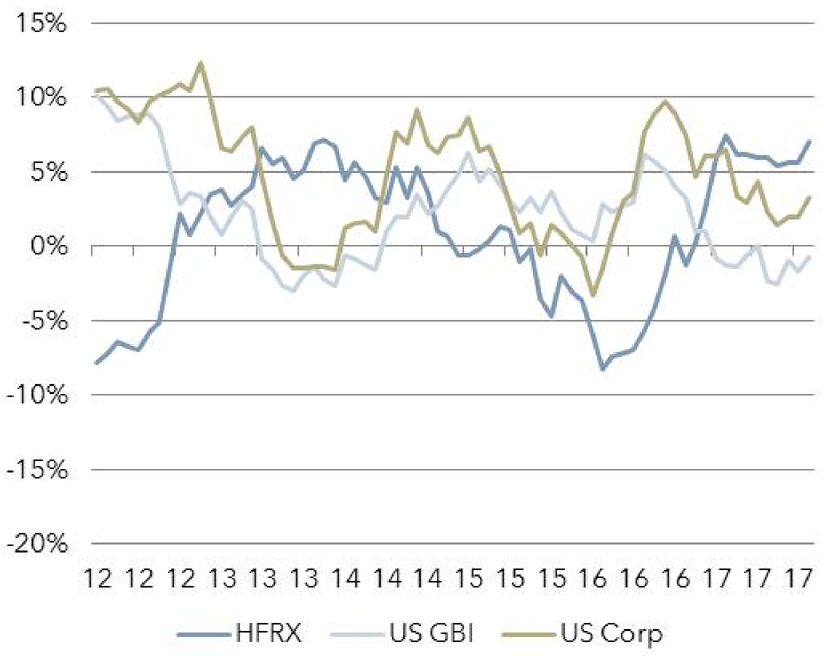


- The reflation regime leads to high correlations between traditional asset classes.
- The performance of Insurance Linked Securities (ILS) is primarily linked to natural events, and therefore largely independent from economic activity. Thus, they offer above-average diversification effects.
- However, ILS is not risk free – history might be misleading.
- Due to the search for yield, risk premiums came under pressure. However, after the last hurricane season, insurance prices should pick up.

Source: VP Bank, Bloomberg

Alternatives: Hedge fund-like strategies

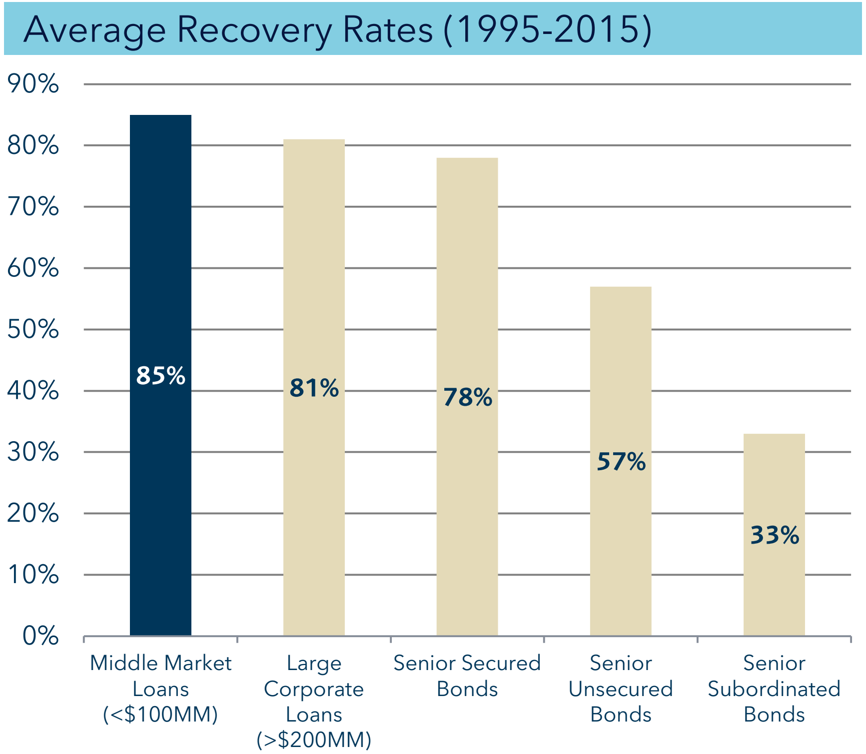
HFRX vs Bonds (YoY)



- Alternative strategies offer interesting opportunities in the well advanced market cycle.
- Due to the higher valuation levels we assess hedge fund-like strategies as interesting addition to traditional asset classes. This kind of solutions have an interesting risk/reward-profile for a low return environment.
- Compared to long only investments, such vehicles have a broader set of instruments available. Therefore e.g. Absolute Return funds are basically in a position to achieve better returns than the bond market.
- Event driven strategies benefit from the M&A cycle, arbitrage strategies from valuation discrepancies – both with low(er) beta.

Source: VP Bank, Bloomberg

Invest in undistorted and underrepresented asset classes: Private Debt

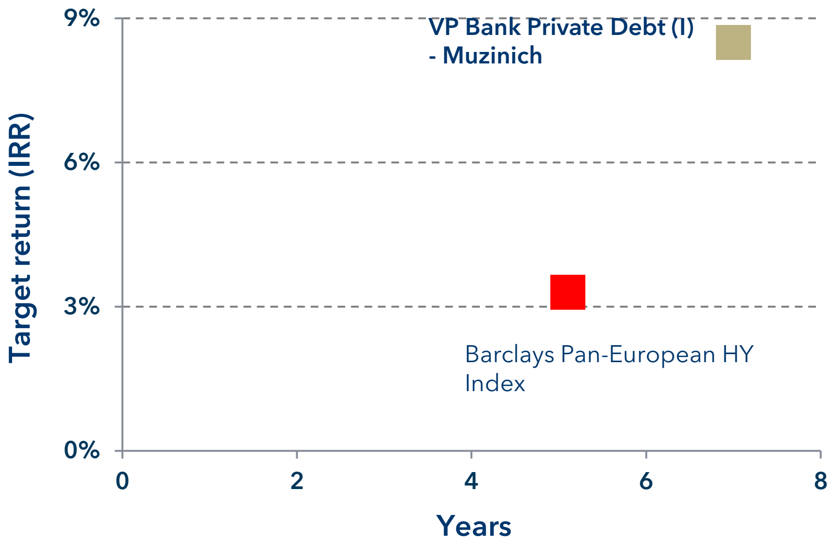


- Private Debt are individually negotiated loans outside the banking system which are not publicly traded.
- As these loans are not publicly traded, prices are not directly distorted by central banks' bond purchasing programmes.
- Long lasting contracts with no interest rate risk as loans are based on a short term rate.
- We prefer the Middle Market segment, which currently offers higher spreads than junk bonds with substantially higher recovery rates.
- Investors compensation also includes an illiquidity premium as investors have to commit for a few years.

Source: S&P LCD; Average recovery rates in the US

Invest into undistorted and underrepresented asset classes: Private Debt

Profile



Advantages of Private Debt

- ✓ Target return (IRR)
- ✓ Total capital loss
- ✓ Duration
- ✓ Diversification

Hurdles

- Liquidity
- Barriers to enter
- Expertise (due diligence)

✓ Mitigated through VP Fund

Source: VP Bank, Muzinich based on S&P (LCD), JP Morgan; Moody's

How to invest

VP Bank Private Debt (I) - Muzinich	
Investors	Professional, institutional and qualified investors only
Distributions	annually
Fund type	Closed end funds – fully funded
Term	7-8 Years (max 10)
IRR* (EUR)	7% - 9%
Focus region	Europe
Currency	EUR
Expected TER	~ 1% p.a.

*Expected Minimum Return; this is no guaranteed minimum return

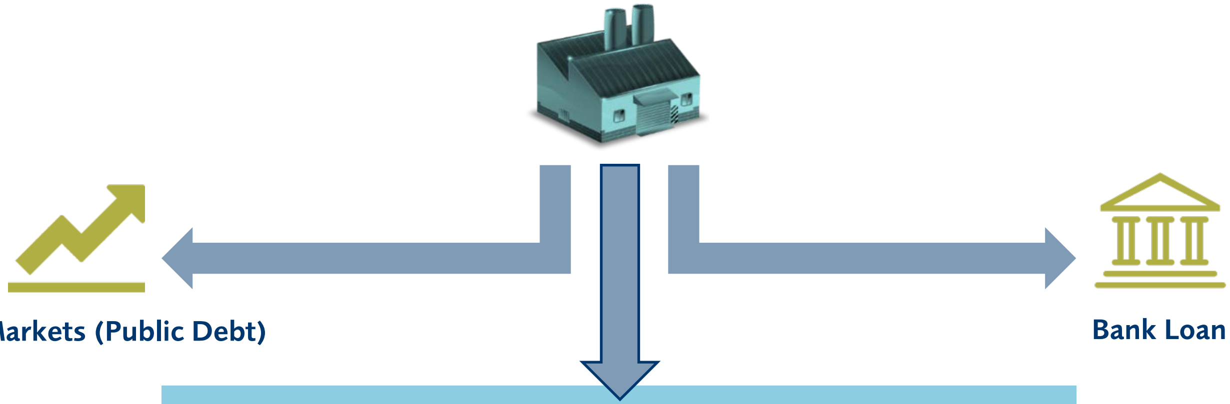
Q&A

Annex

Our definition of Private Debt

Individually negotiated loan - not publicly traded – outside the banking system

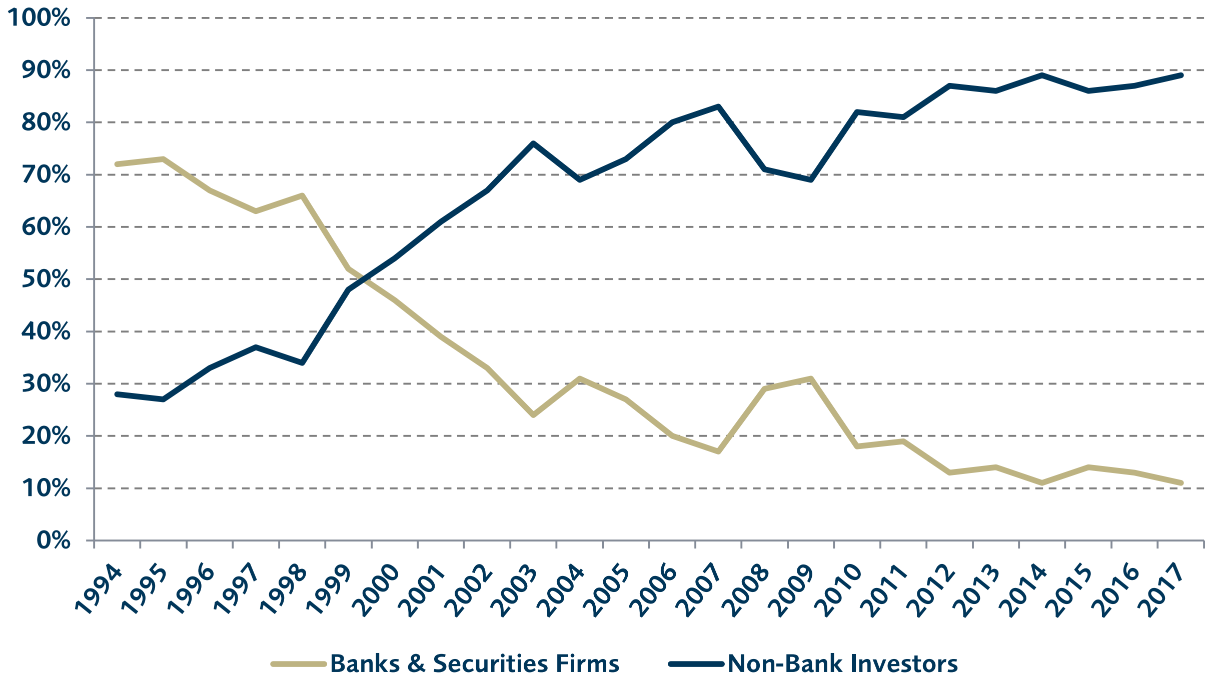
A company's sources of debt financing



Private Debt

- Directly negotiated
- No bank financing
- SMEs with limited access to capital markets
- Big caps facing complexity and time constraints
- No rating costs

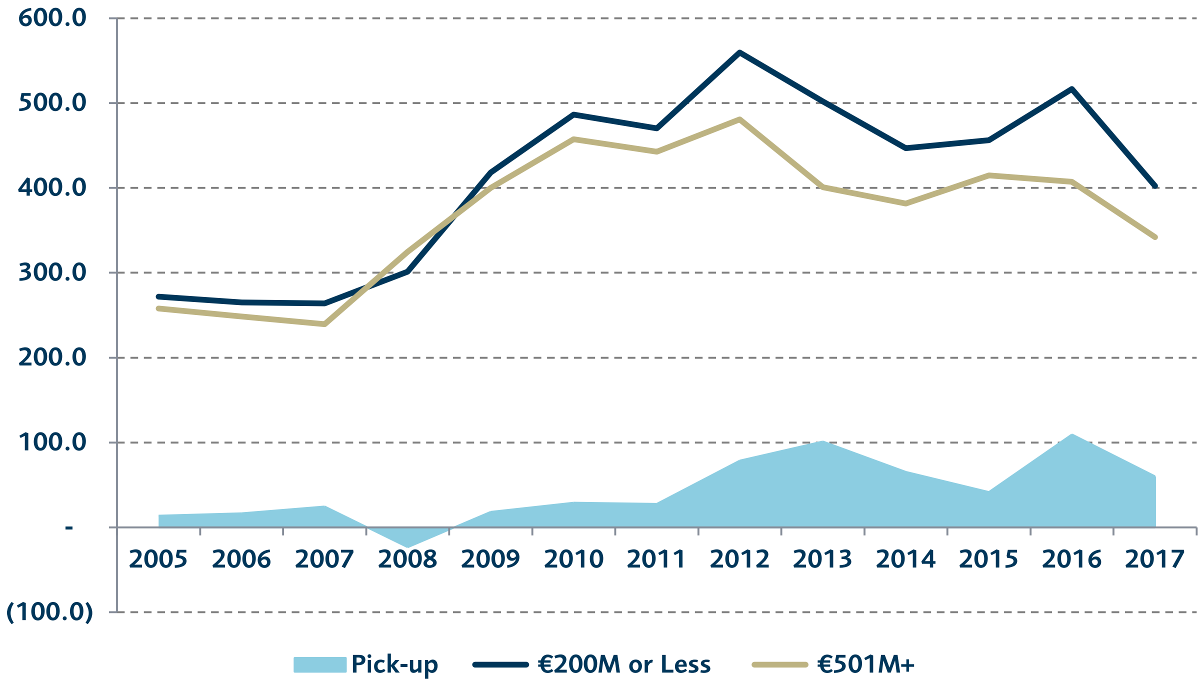
Why invest - Structural opportunity
US Bank role as % of leveraged loan market



Source: S&P LCD; market share of leveraged loans

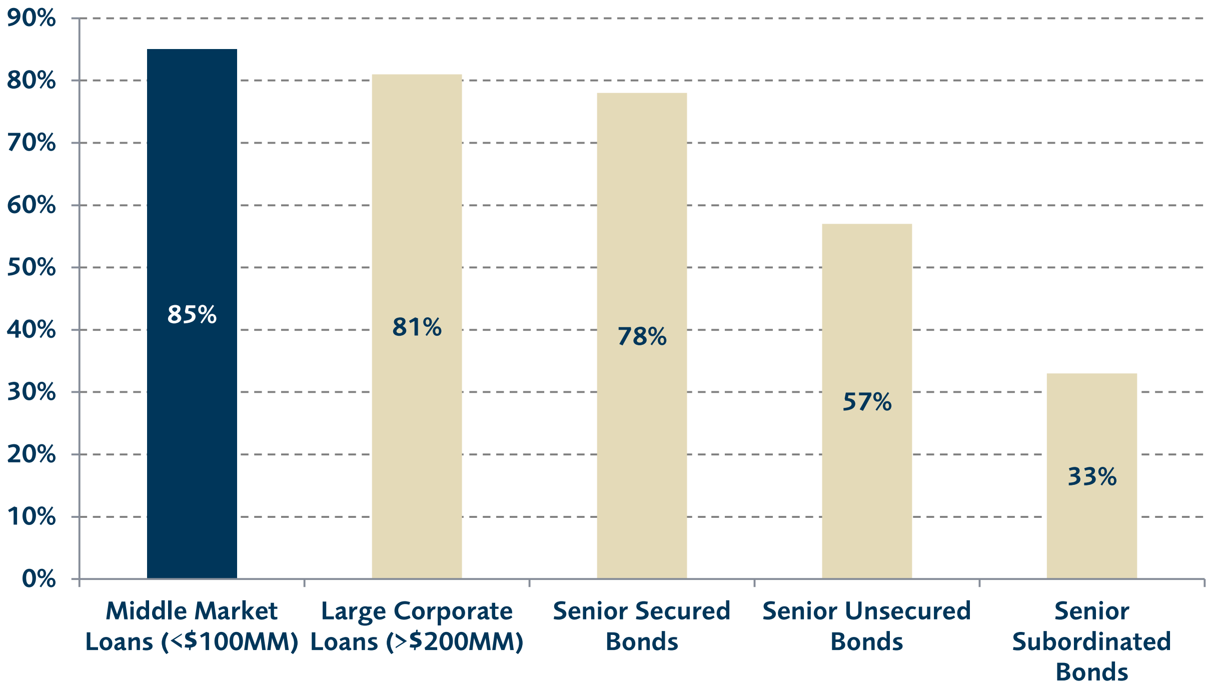
Why invest - Higher return

European Term Loan Margins – Large Syndicated vs Middle Market



Source: S&P LCD; European term loan B margins

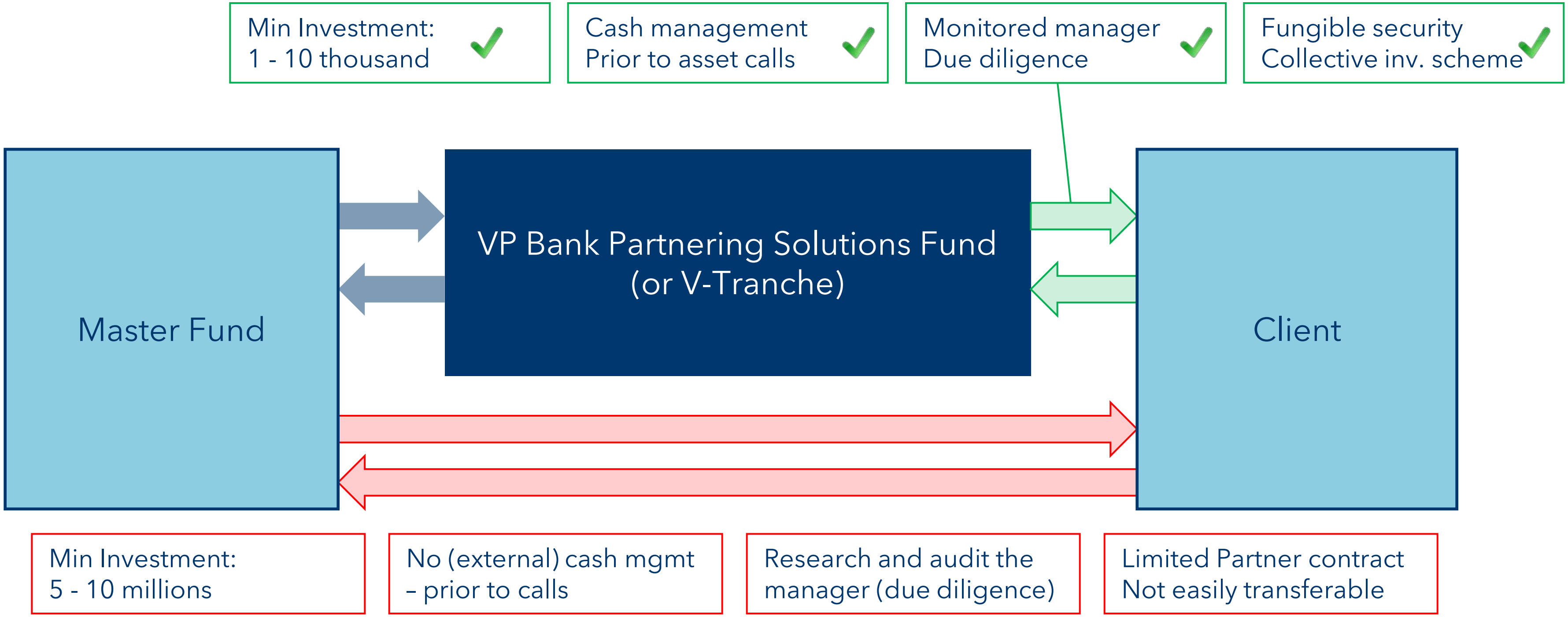
Why invest - Lower Risk
Average Recovery Rates 1995 - 2015



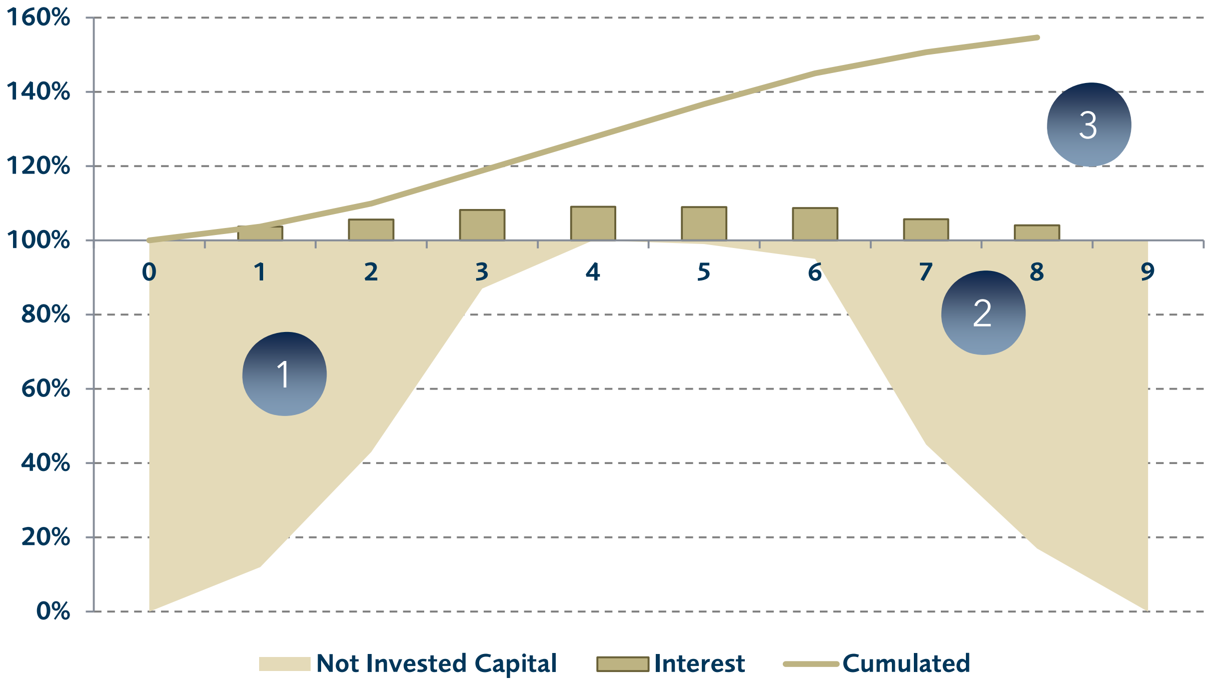
Source: S&P LCD; Average recovery rates in the U.S.

What is our value proposition?

Layer to address additional services



Modelled expected parameters
Underlying strategy concept



1. Ramp-up period

2. Lifetime

3. Return

Source: VP Bank

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