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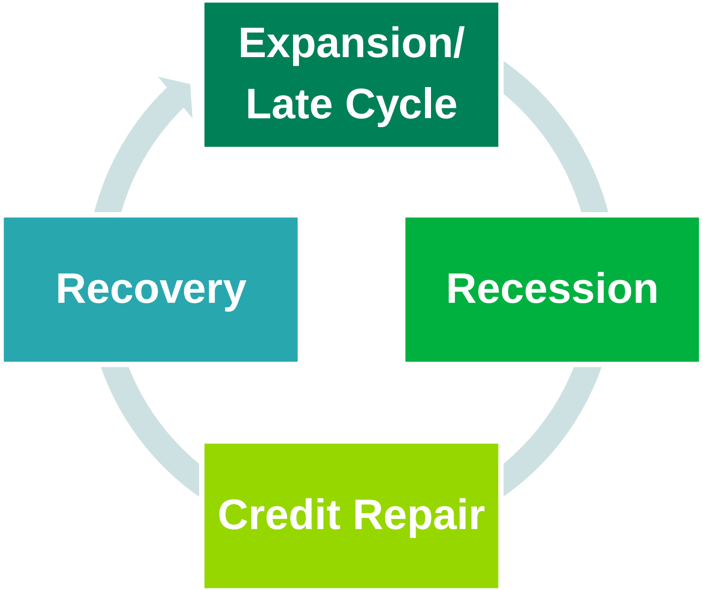
Positioning for late cycle as rate cuts begin

Agenda

Economic data is changing – Where are we in the Cycle?

- Global **economies synchronised** when the **Covid pandemic** struck in 2020
  - > Recessionary conditions took hold, with economic growth contracting
- Policy responses were similar but not uniform, however most **regions enjoyed a strong recovery**
- **Growth diverged** thereafter –
  - > **US** consumers enjoying more **generous stimulus packages**, and responded by bolstering economic growth
  - > The **war in Ukraine** created an **energy crisis**, which had a greater impact on the Eurozone and UK
- **Growth rates** are now **converging** again, from different directions, as the US economy slows, while Europe expands
- The recent **jump in the US unemployment** rate has ignited **fears of a harder landing**, but other data remains supportive



What does Late Cycle mean?

- The **economy** continues growing, but rate slows and ultimately falls below potential, but still positive
- **Inflation** comes off the cycle highs
- **Monetary policy rates** peak and then become less restrictive
- **Labour markets** look tight, and the unemployment rate is low
- **Companies get creative** to boost growth as it becomes more difficult to hit targets organically
  - > This usually means increased M&A and LBO activity as well as more leverage
- **Consumers** on average look more stretched and delinquencies start to tick up, particularly in lower income cohorts
- **Banks** might relax their credit standards
- **Spreads** rally to below their long-term averages
- **Government bond curves** move from upward sloping to flat/ inverted, as recession fears build

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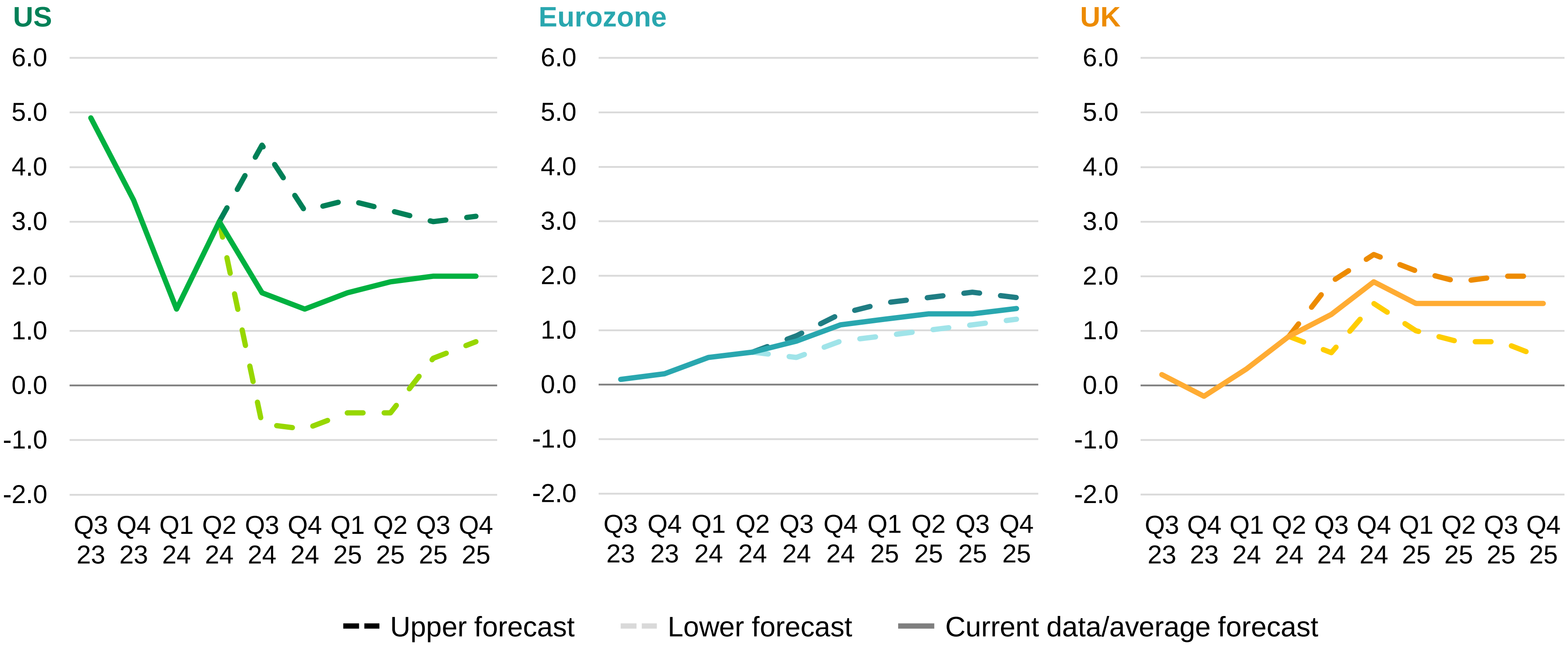
Growth rates are/will be below potential but still positive

GDP forecasts (% QoQ annualised)



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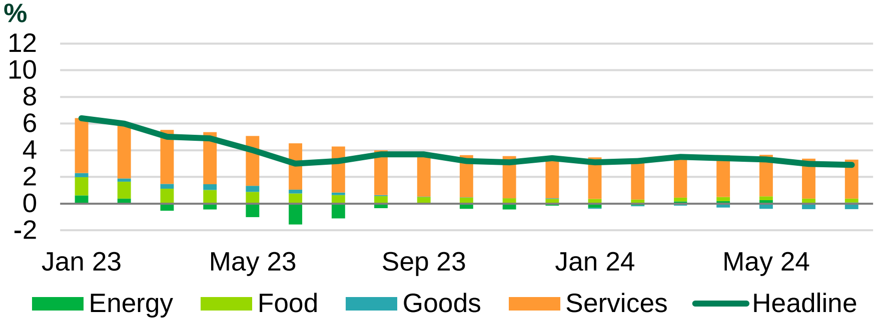
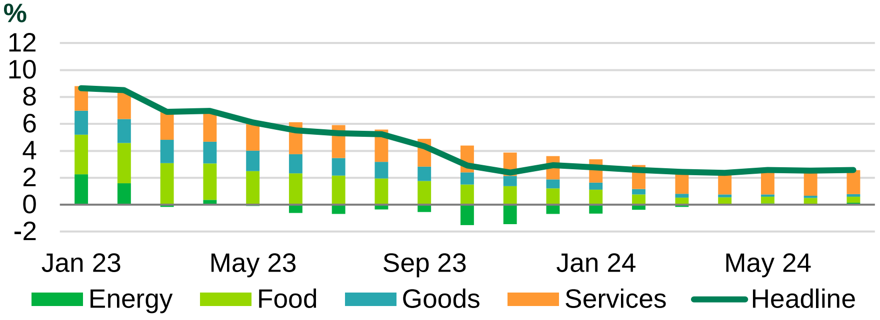
Source: Bloomberg, Latest data available as at 3 September 2024

Inflation rates have declined close to CB targets

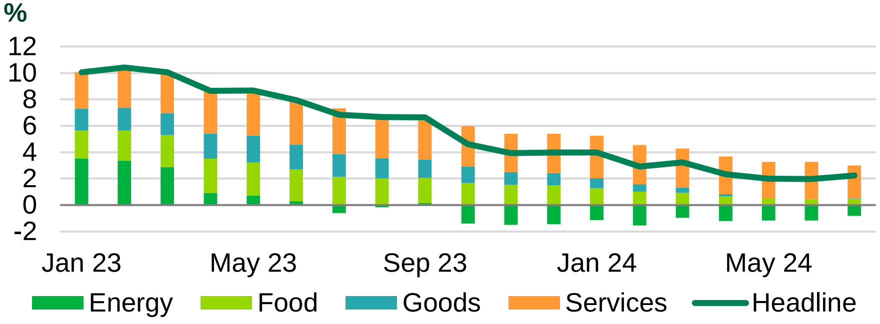
US



Eurozone



UK

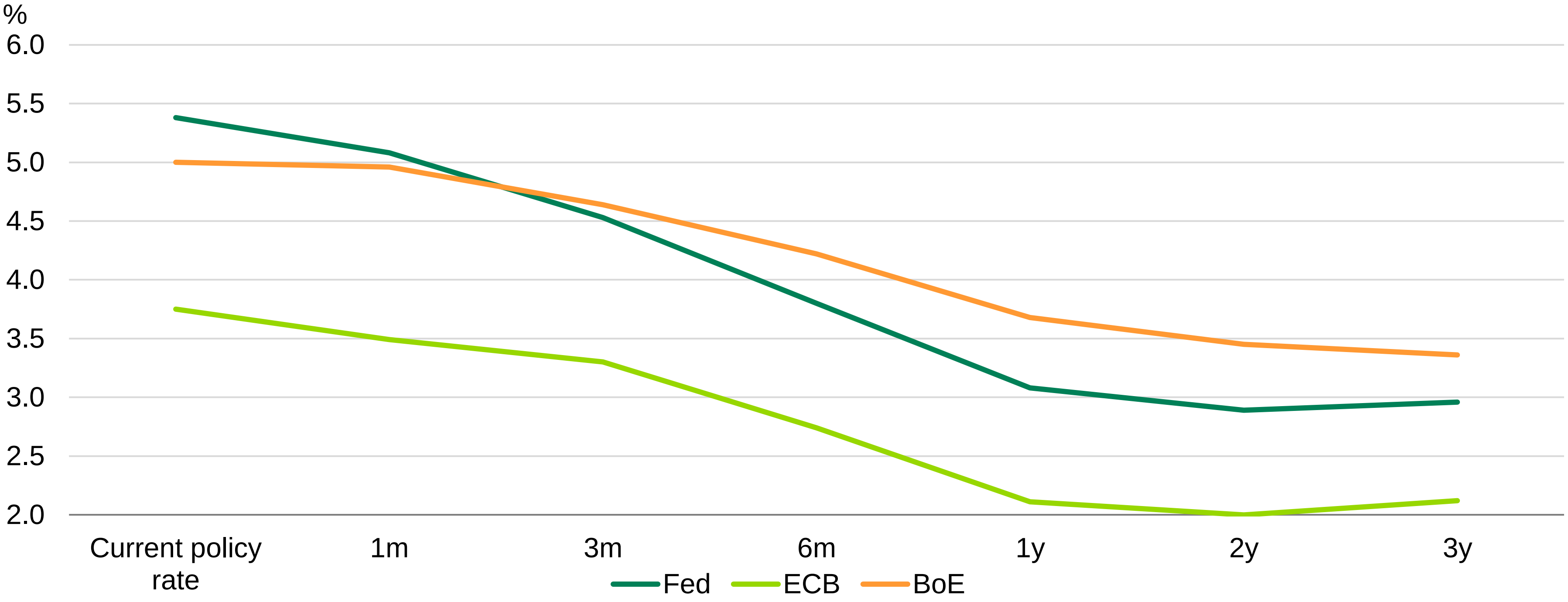


- Shelter prices have been extremely strong in the US, accounting for over 60% of services inflation
- The ECB now forecasts that inflation will get to target in Q4 2025, and will then be 1.9% in 2026
- The Bank of England was the first to achieve its 2% target; UK is expected to rebound to 2.6% in a year's time but then be below target in 2026

Forecasts based on external analysis; not guaranteed; and actual results may differ materially.
Source: Bloomberg, Eurostat, ONS; Latest data available as at 3 September 2024

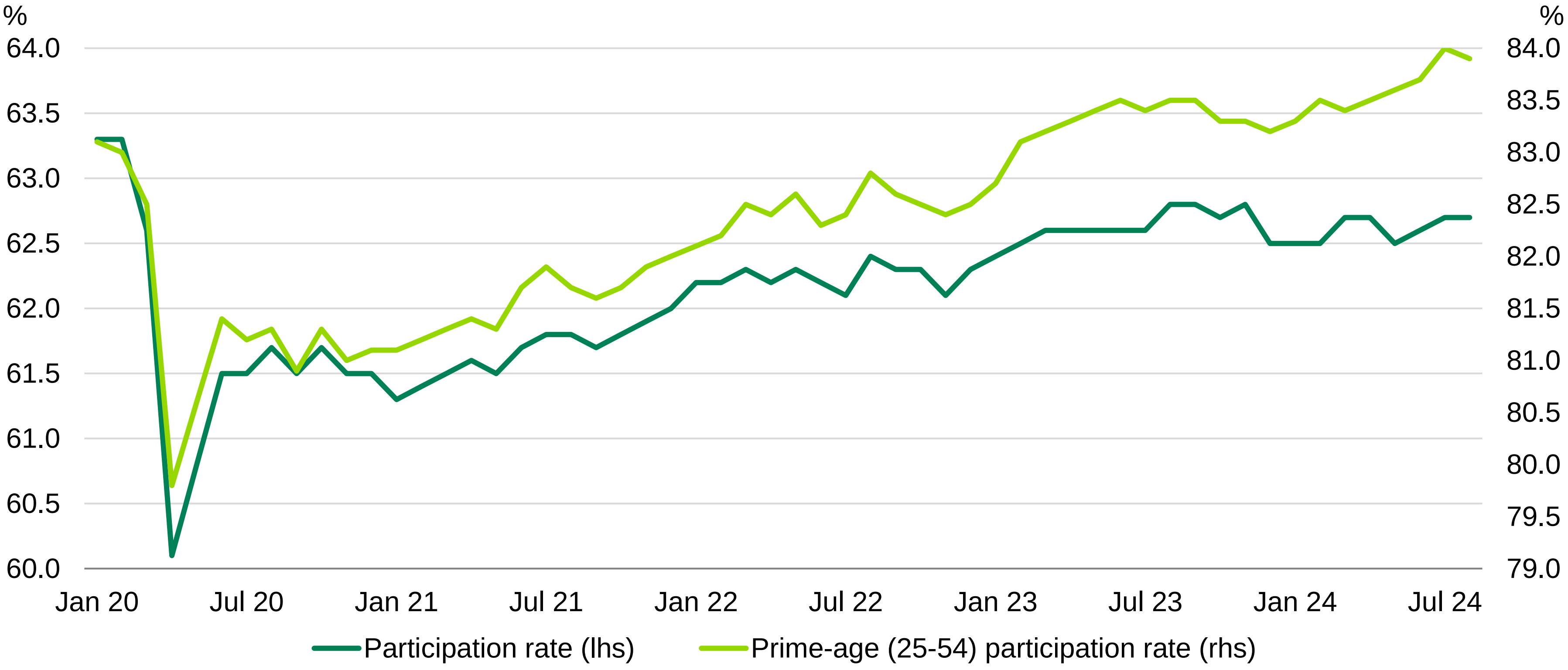
Monetary policy is expected to become less restrictive

Monetary Policy rate expectations



Source: Bloomberg; Latest data available as at 9 September 2024

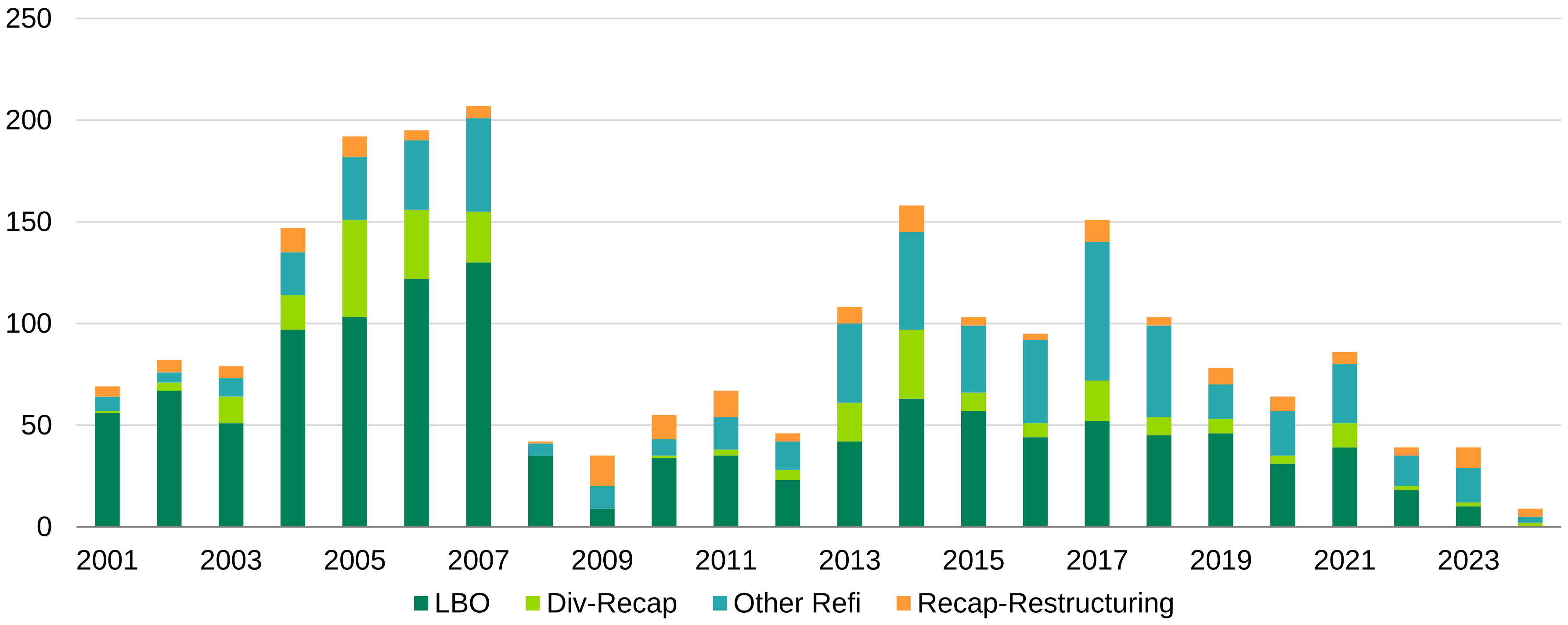
Higher unemployment rate, but labour supply is strong



Source: Bloomberg; Latest data available as at 9 September 2024

Not much evidence of excesses in European High Yield

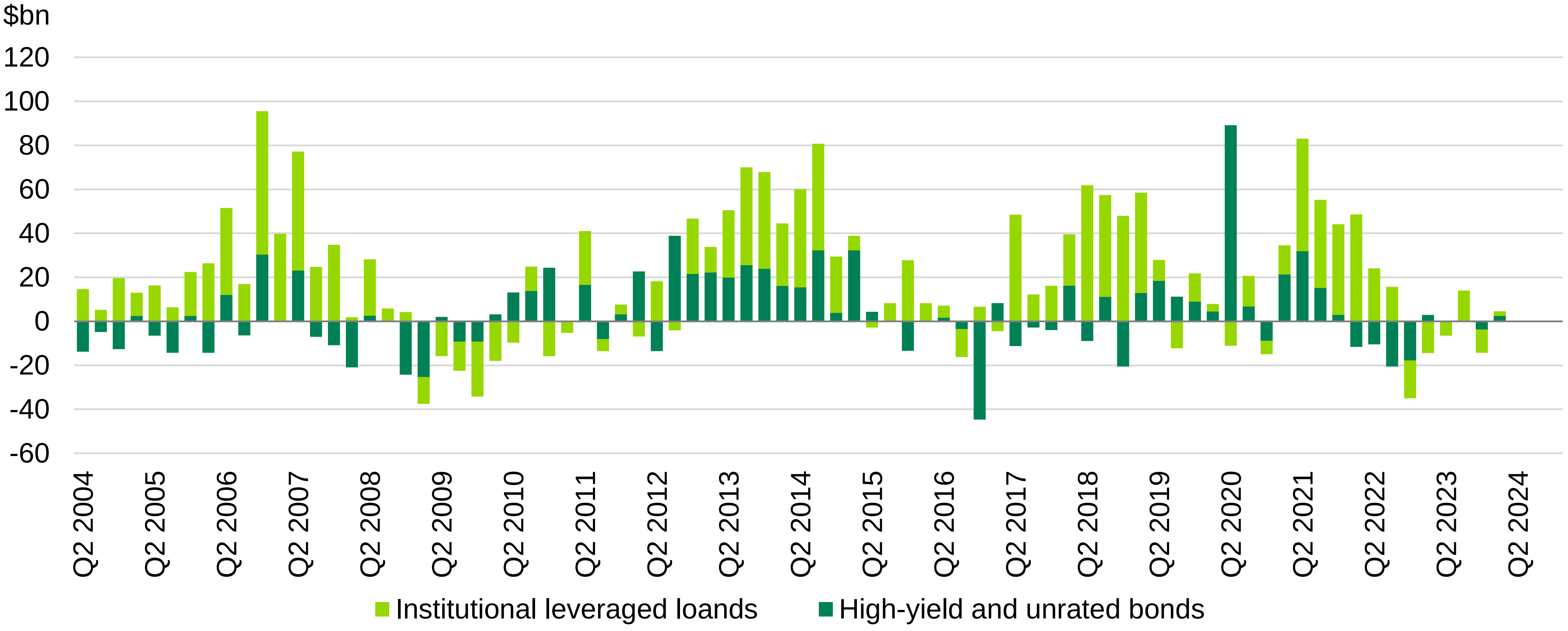
Number of European High Yield Deals



Source: Fitch; Latest data available as at August 2024

Or in the US

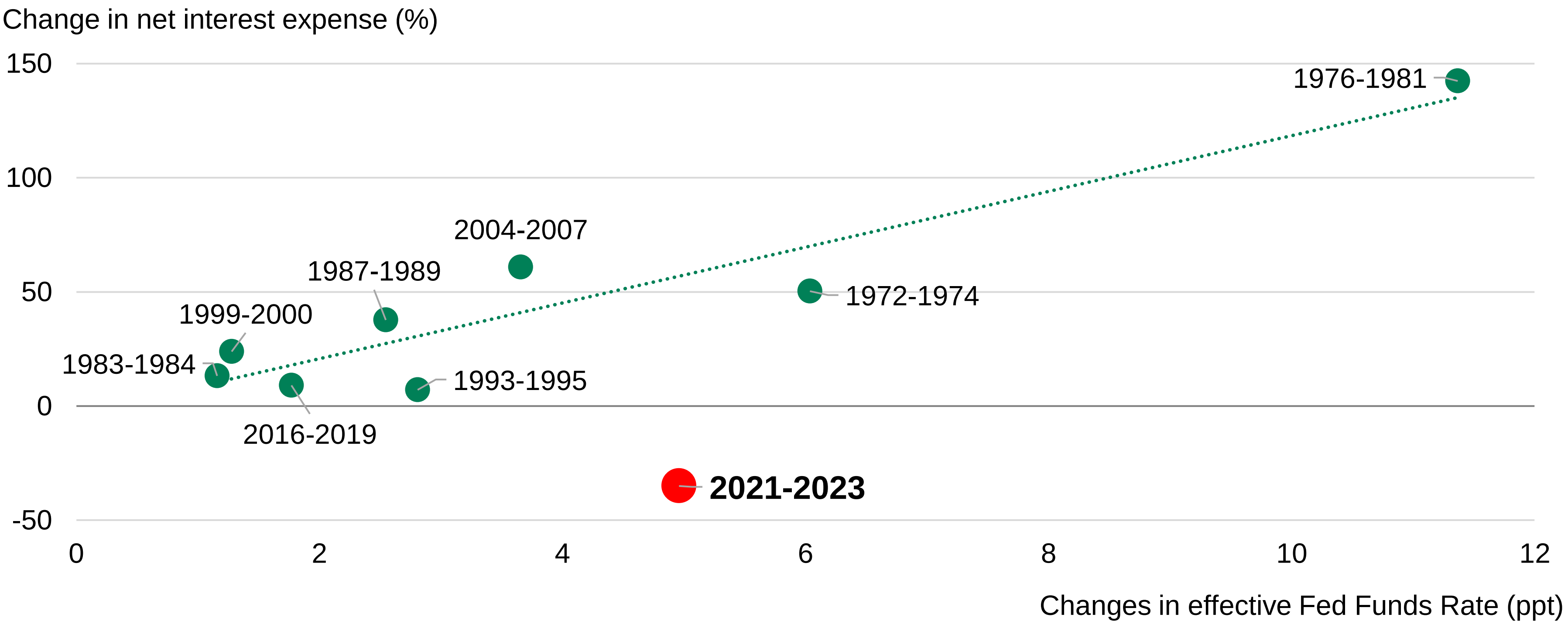
Net issuance of risky debt



Source: Mergent, Inc., Fixed Income Securities Database; PitchBook Data, Leveraged Commentary & Data, Fed Financial Stability Report, April 2024

Corporations have not felt the impact of rate hikes

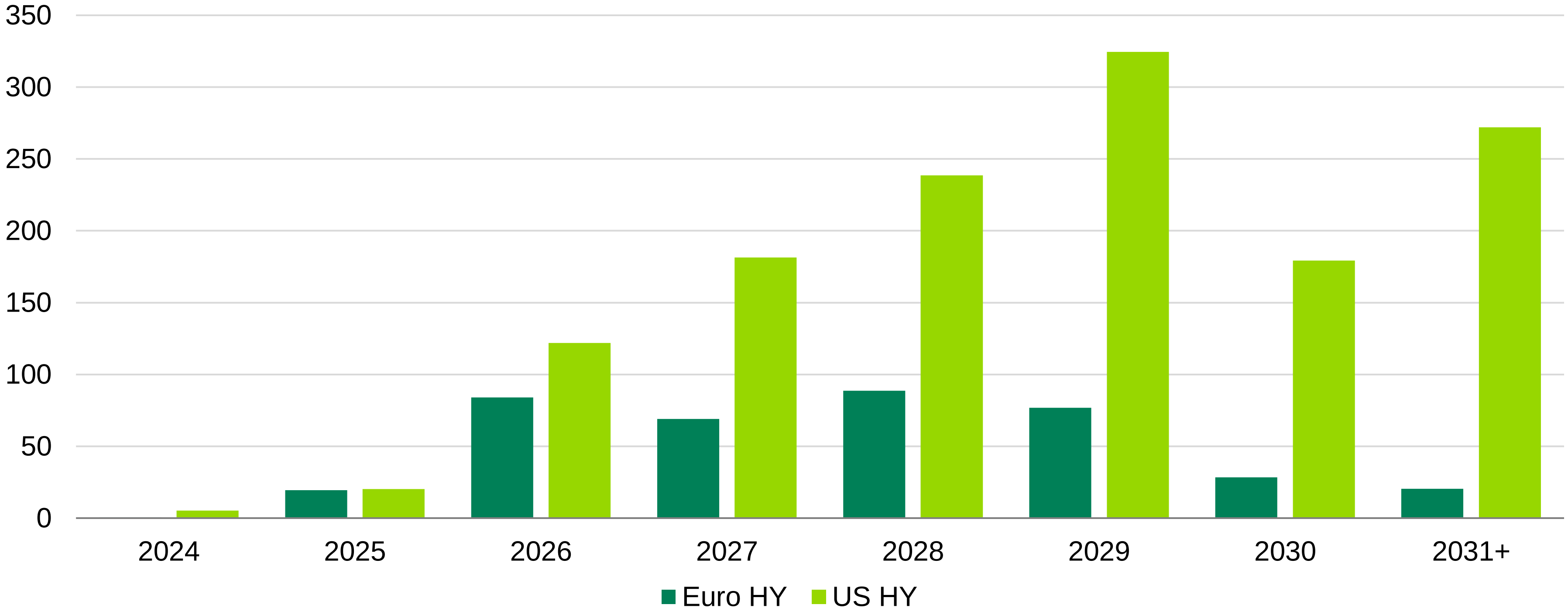
NFC's net interest payments during monetary policy tightening cycles



Source: IMF; July 2024

HY companies have extended maturity schedule

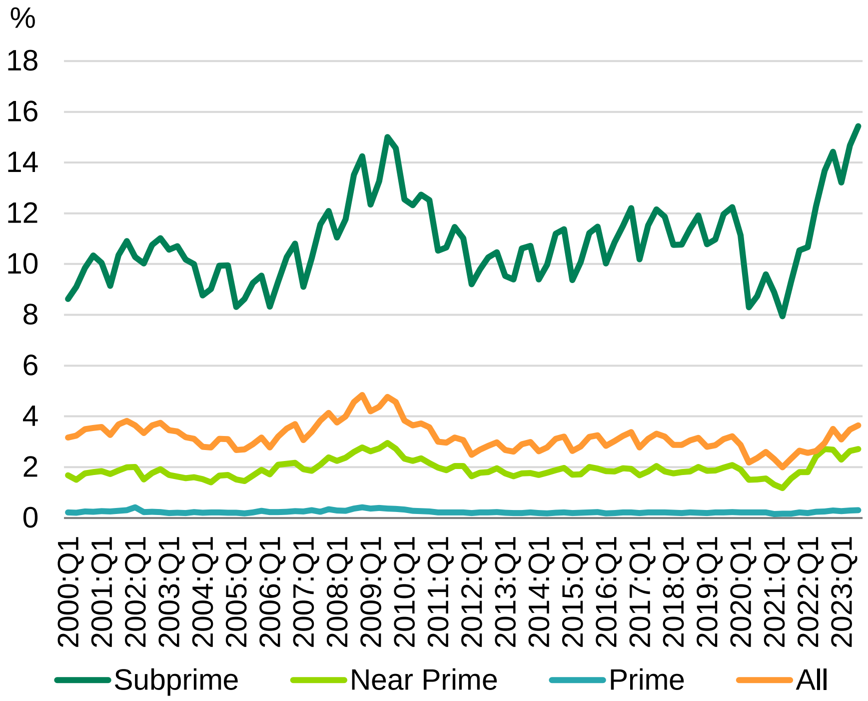
HY maturity wall



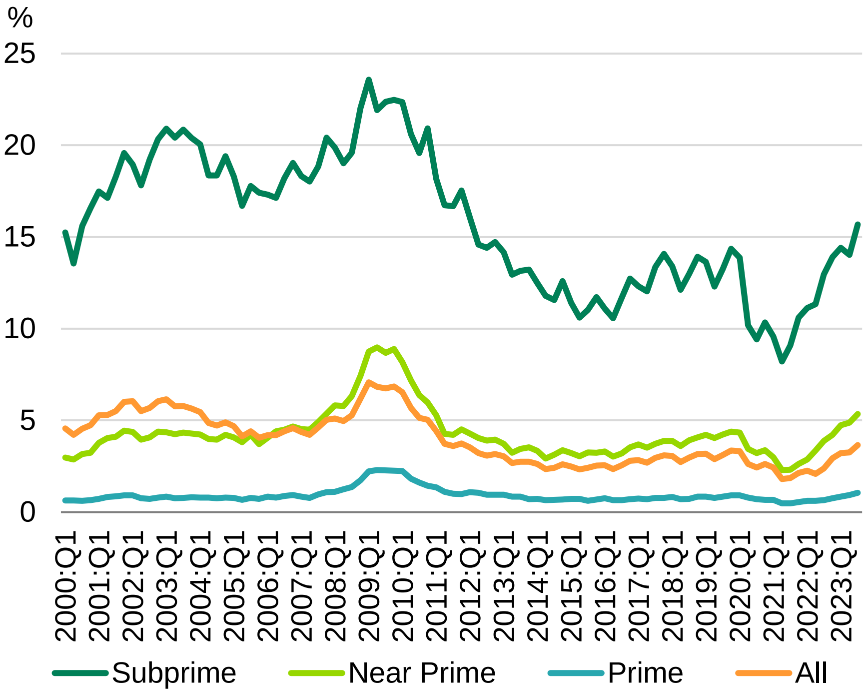
Source: Bloomberg, August 2024

Delinquencies ticking up – United States

Auto delinquency rates



Credit card delinquency rates



Data source: TwentyFour, Bloomberg; Federal Reserve; Latest data available as at 3 September 2024

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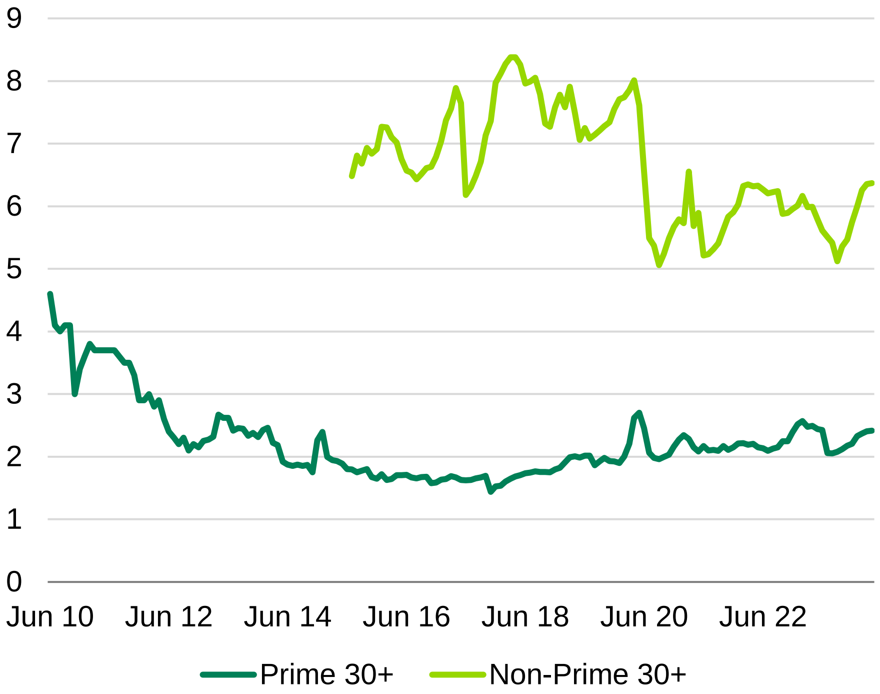
Delinquencies ticking up to a lesser degree in the UK and EZ

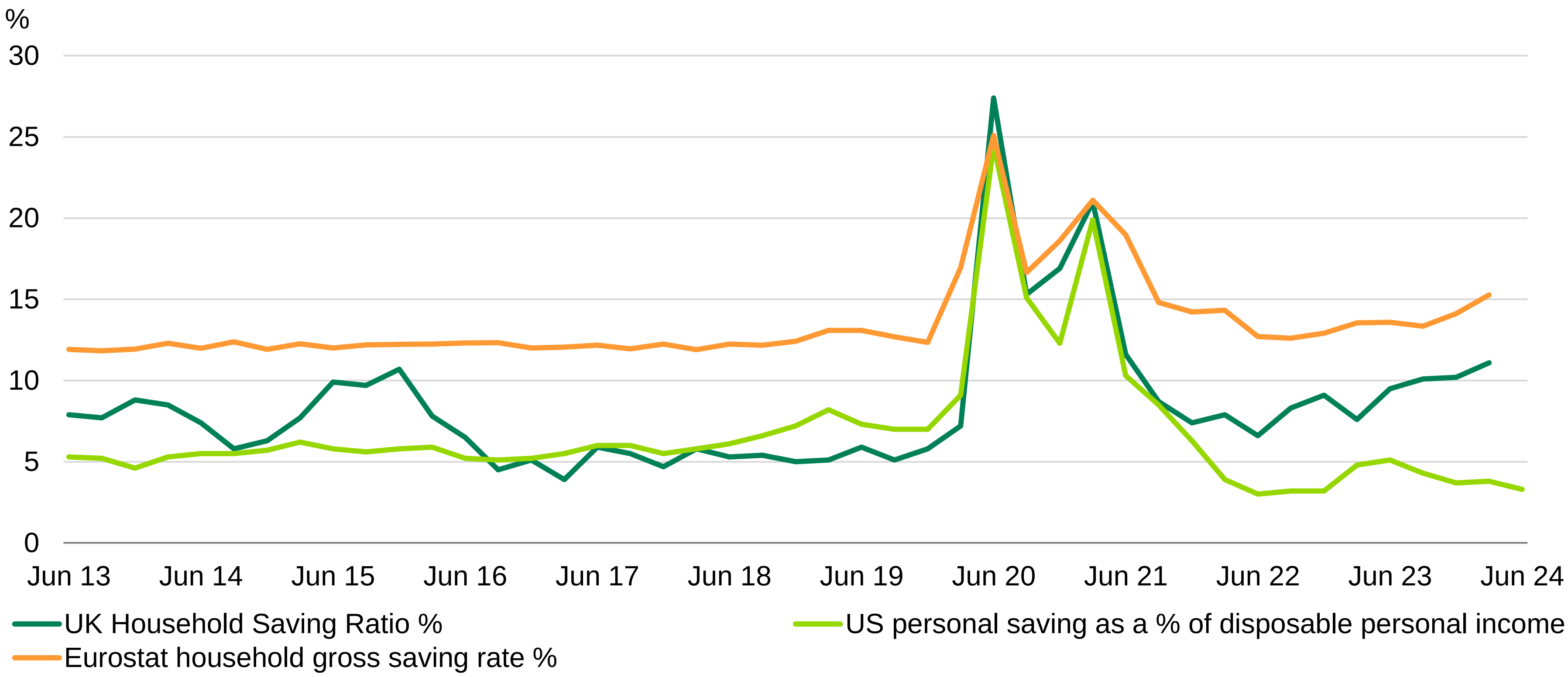
Credit card 30+ arrears – UK



Euro Consumer 30+ arrears – Eurozone

Data source: Intex; Latest data available as at 3 September 2024

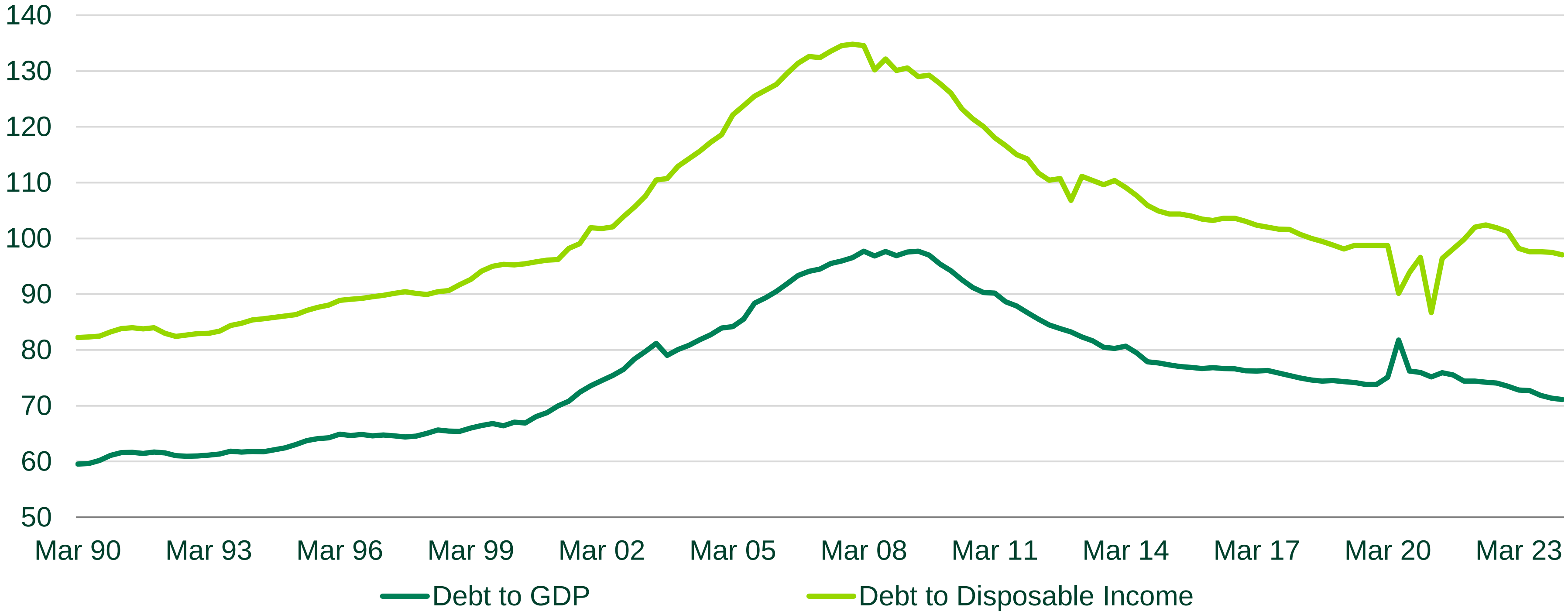
Household savings ratios



Data source: Bloomberg; Data latest released as at September 2024

Household Debt ratios have improved since the GFC

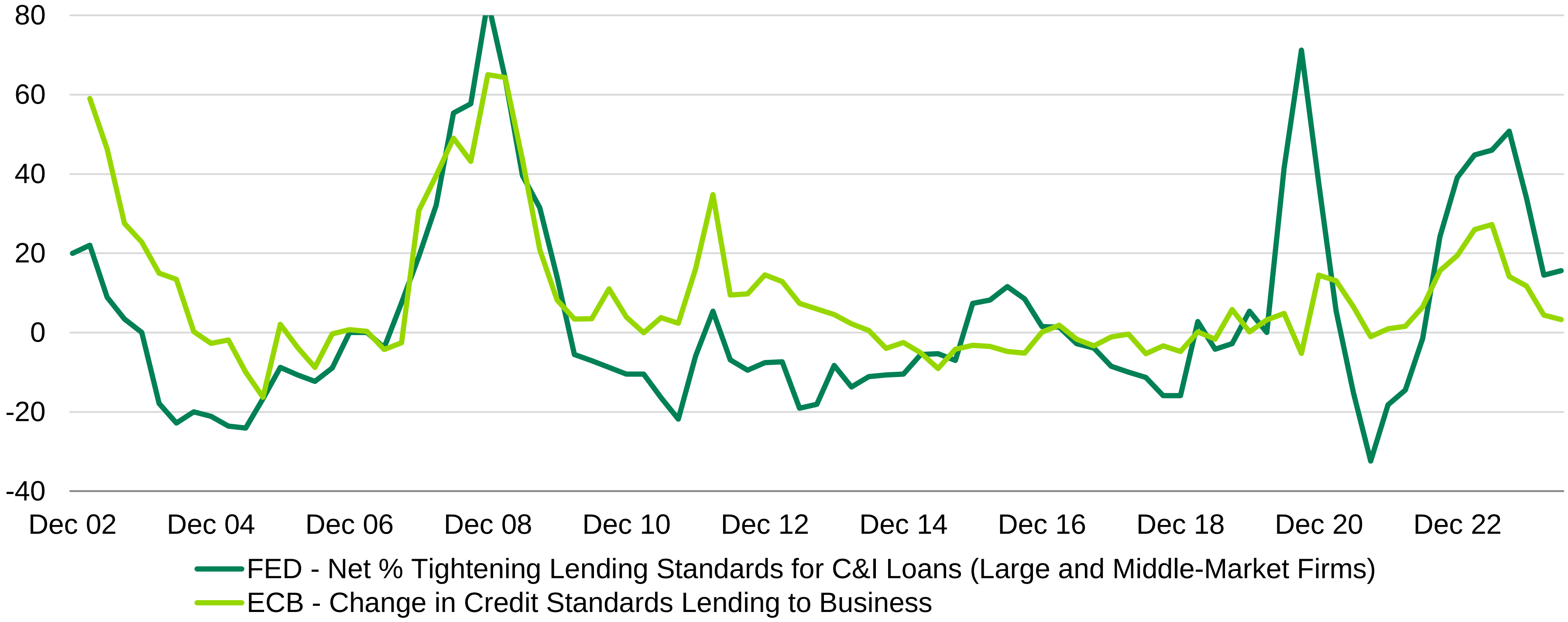
US Household Debt (%)



Data source: Bloomberg; Data latest released as at 3 September 2024

Bank lending standards are becoming more neutral

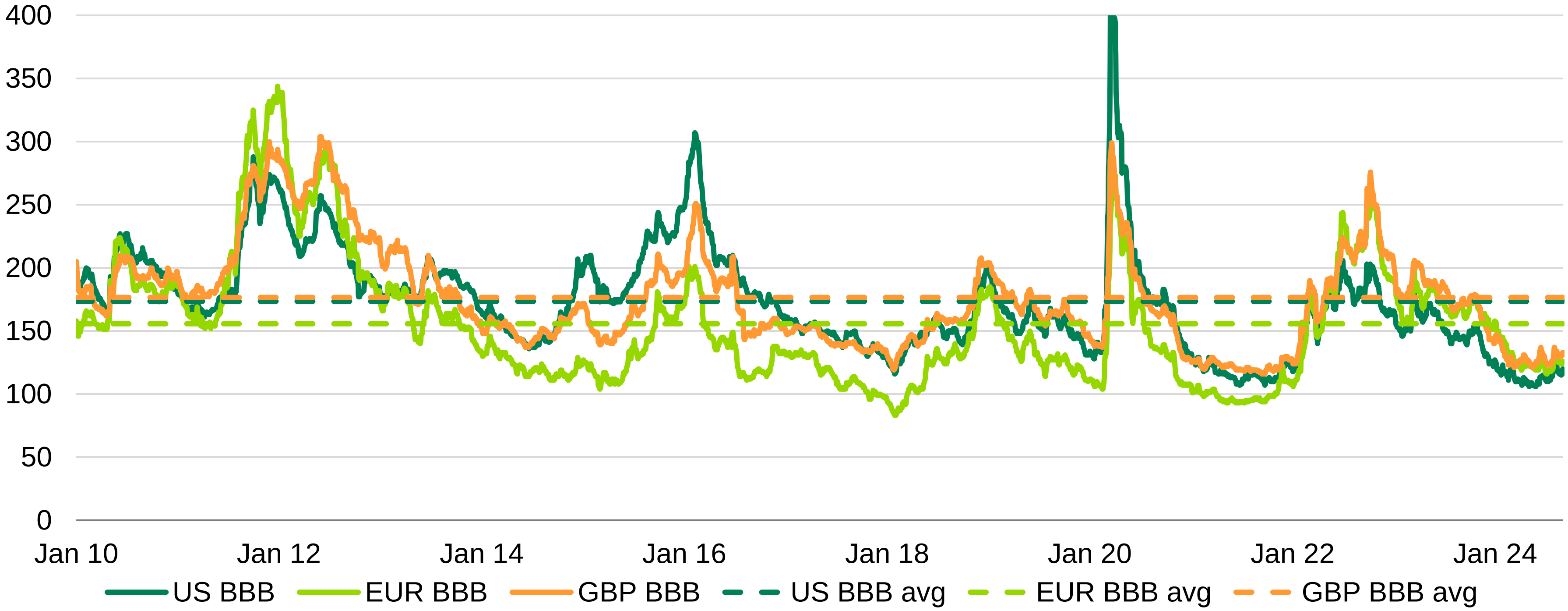
FED/ECB – net % tightening lending standards for C&I loans (large and middle-market firms)



Source: Bloomberg; Latest data available as at 31 August 2024

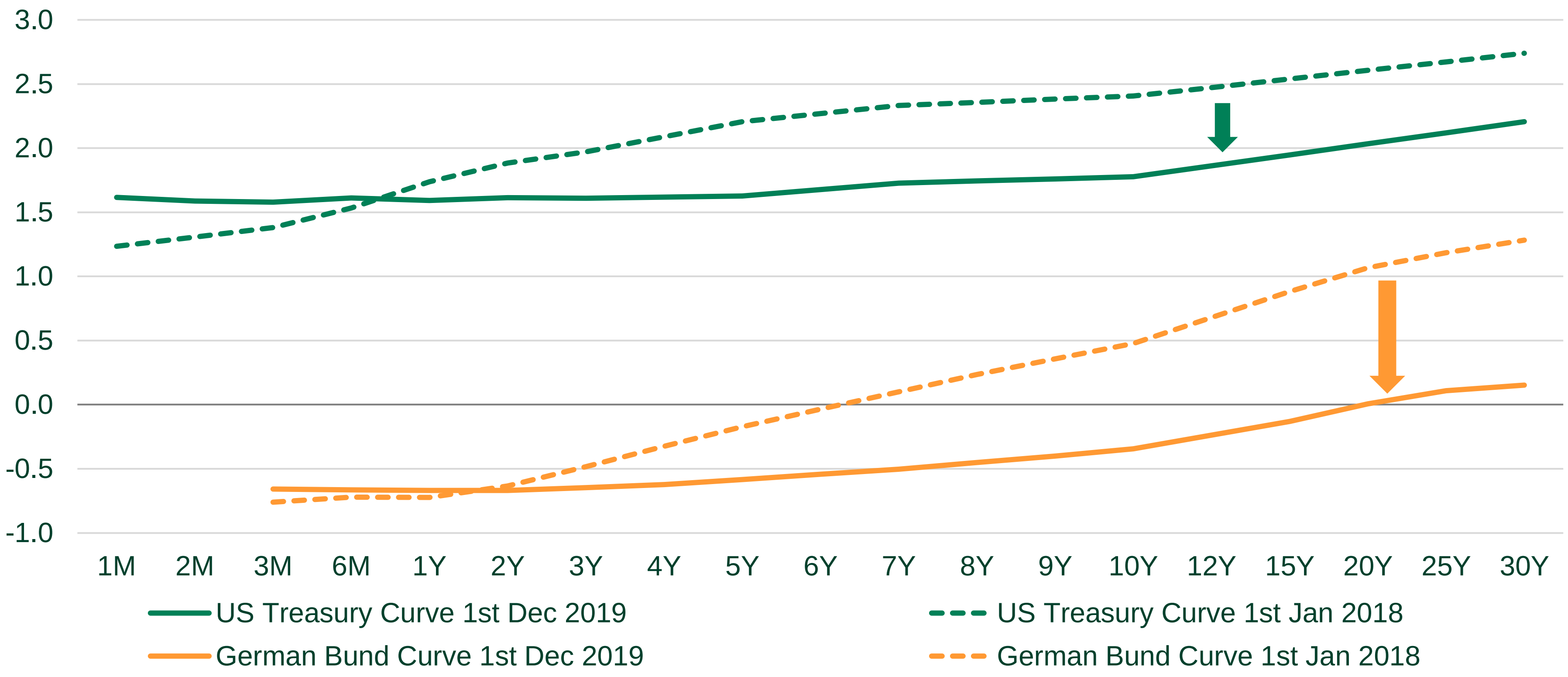
Spreads are below long-term averages

BBB Spreads US/EUR/GBP



Source: Bloomberg; as at 4 September 2024

Yield curves tend to flatten in late cycle



Source: Bloomberg; Latest data available as at 31 July 2024

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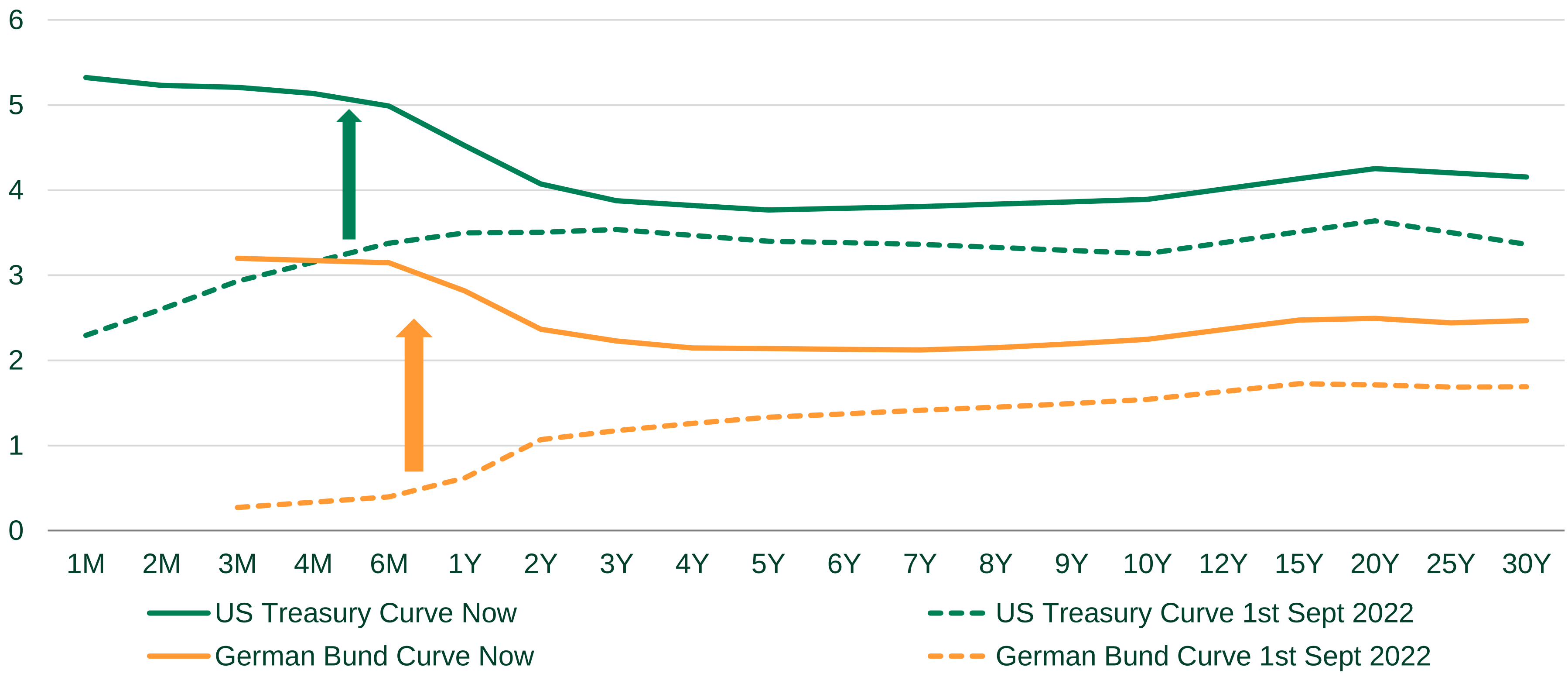
Not so this time, with curves inverted since July '22



Source: Bloomberg; Latest data available as at 31 July 2024

Late Cycle indicators have increased steadily

The **economy** continues growing, but rate slows and ultimately falls below potential, but still positive	✓
Inflation comes off the cycle highs	✓
Monetary policy rates peak and then become less restrictive	✓
Labour markets look tight, and the unemployment rate is low	✓
Companies get creative to boost growth as it becomes more difficult to hit targets organically > This usually means increased M&A and LBO activity as well as more leverage	✗
Consumers on average look more stretched and delinquencies start to tick up, particularly in lower income cohorts	~
Banks might relax their credit standards	✗
Spreads rally to below their long-term averages	✓
Government bond curves move from upward sloping to flat/ inverted, as recession fears build	~

What is different this time?

Recessions are often **caused by** the impact of **Central Bank policy**

> Tighter financial conditions negatively impact companies' ability to refinance – **not the case currently**

Central Banks are in strong position to help, given the high base rates

Eurozone and UK growth seems to have **rebounded** – "recession" was energy led, not an "end of cycle"

Company and **Household "excesses**" are **not** as **obvious** in this cycle

> Covid impact caused a default cycle, weaker companies failed, while others braced for recession
> Leverage stayed low due to higher yields
> Consumers in EZ and UK remained prudent in the face of the cost-of-living crisis and energy shock
> Covid packages supported consumers in the US, but low savings rate is impacting some cohorts

Money sitting **in "safer" assets**, ie Money Market Funds

Government debt is very high, **as are deficits**

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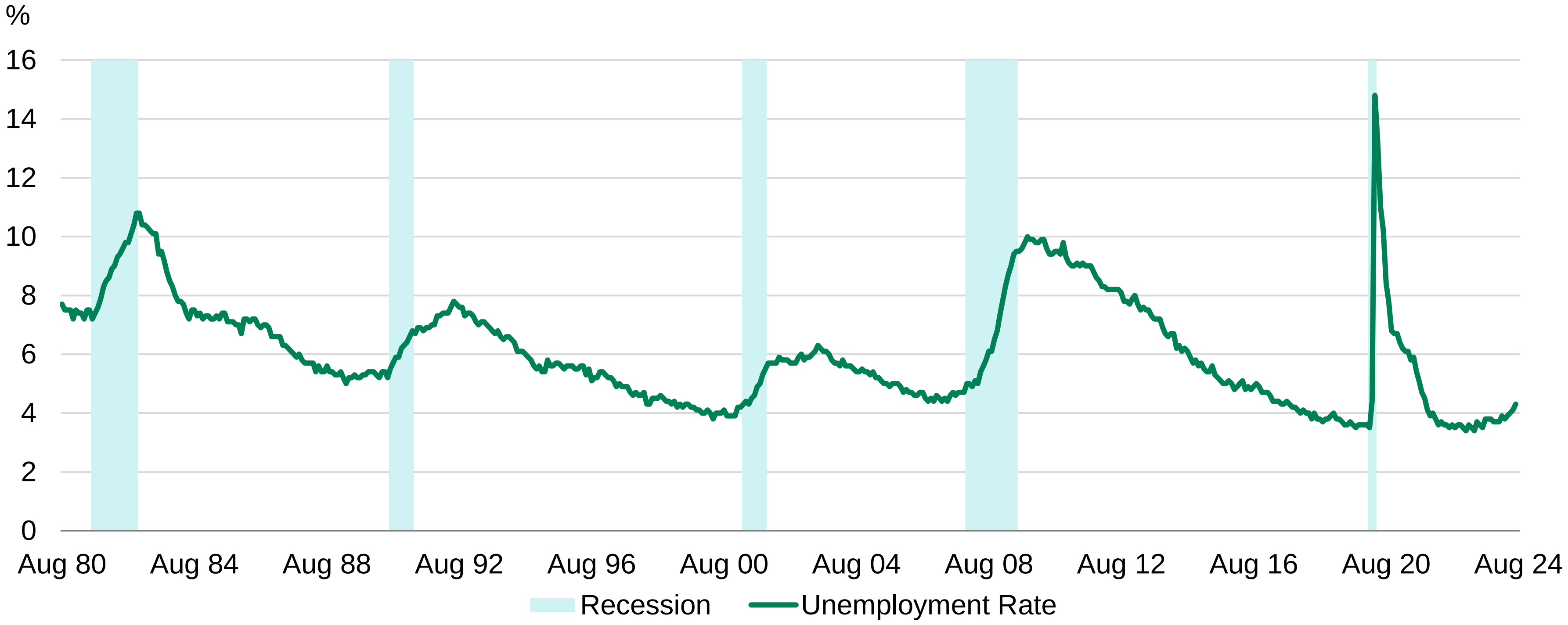
Are there signs that point to a harder landing in the US?

Its all about the Labour market at the moment – slow down more synchronised with economy



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Data source: Bloomberg, as at 31 August 2024

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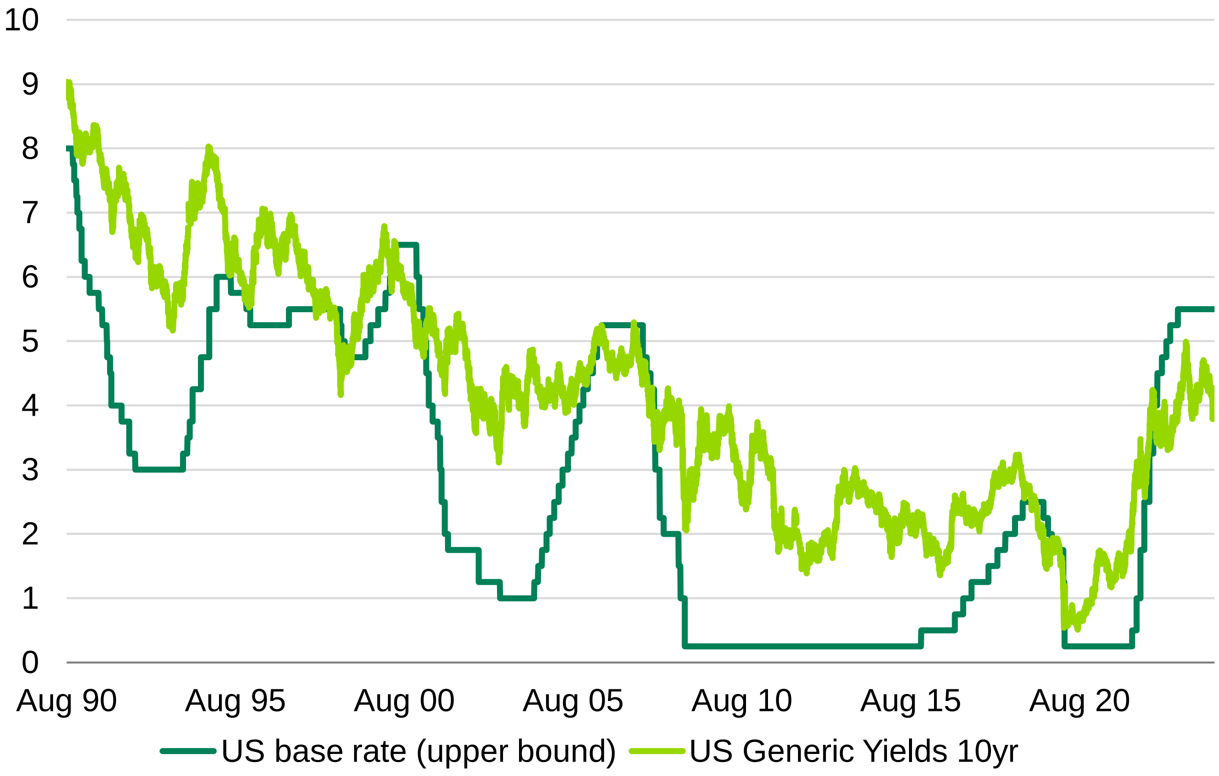
The Curve, "Normalisation" and Terminal rates

- 2s10s curve has been inverted since July 2022,
  - > Recently flattening on hopes of a rate cutting cycle
- Markets (and Fed) are predicting base rates at 3-3.25% in 3 years
  - > Long-term Fed projections are at 2.75%
- Curve has to normalize, eventually



Data source: Bloomberg, as at 22 August 2024

Factors that may impact the cycle

US elections

Heightened geopolitical risks

Monetary Policy vs **Fiscal Policies**

Technical drivers

Strength of the consumer

Struggling Chinese economy

AI efficiencies

Not at **Inflation** endgame just yet

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Late Cycle Playbook

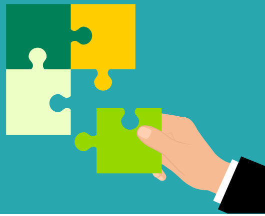
- Late cycle conditions can last for long periods of time, **patience and prudence is required**

- **Yields** are **attractive** and **carry** should **reward investors**, however;
  - > Move up in credit quality as additional spread for lower rated credit is not particularly attractive
  - > Reduce credit spread duration – helped by inverted curve and flat credit curve
  - > Reduce or eliminate the more cyclical sectors
  - > Consider Government Bonds to provide balance
  - > Increase liquidity and flexibility
  - > Economic conditions remain favorable for credit funds

What could be different this time around?

- Flat/Inverted Curve
- Technical Drivers

Fixed Income positioning:
Be Prudent, but be Invested



- Tricky stage with risks tilted to a US slowdown, and low growth in the Eurozone and UK
- Easing policy from Central Banks should support the economy and markets
- Nevertheless, its sensible to have a more prudent outlook
  - > Yields and Carry are attractive, while economic conditions become clearer
  - > Government bonds give protection, but sizing and duration should be linked to credit positioning
- Technical drivers could play an important role

Flexibility and Liquidity are very important

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Panel discussion

Felipe Villarroel
Partner,
Portfolio Manager
TwentyFour AM

Rupert Watson,
Head of Asset Allocation,
Mercer Investments

Pete Drewienkiewicz,
Chief Investment Officer,
Redington

Duncan Toms,
Associate Director,
Multi-Asset Strategist,
HSBC

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