

# Embedded Risks in the Credit Market



**June 14, 2018**

**JPM Credit Hedge Fund Forum**

**The Spectrum Fund**



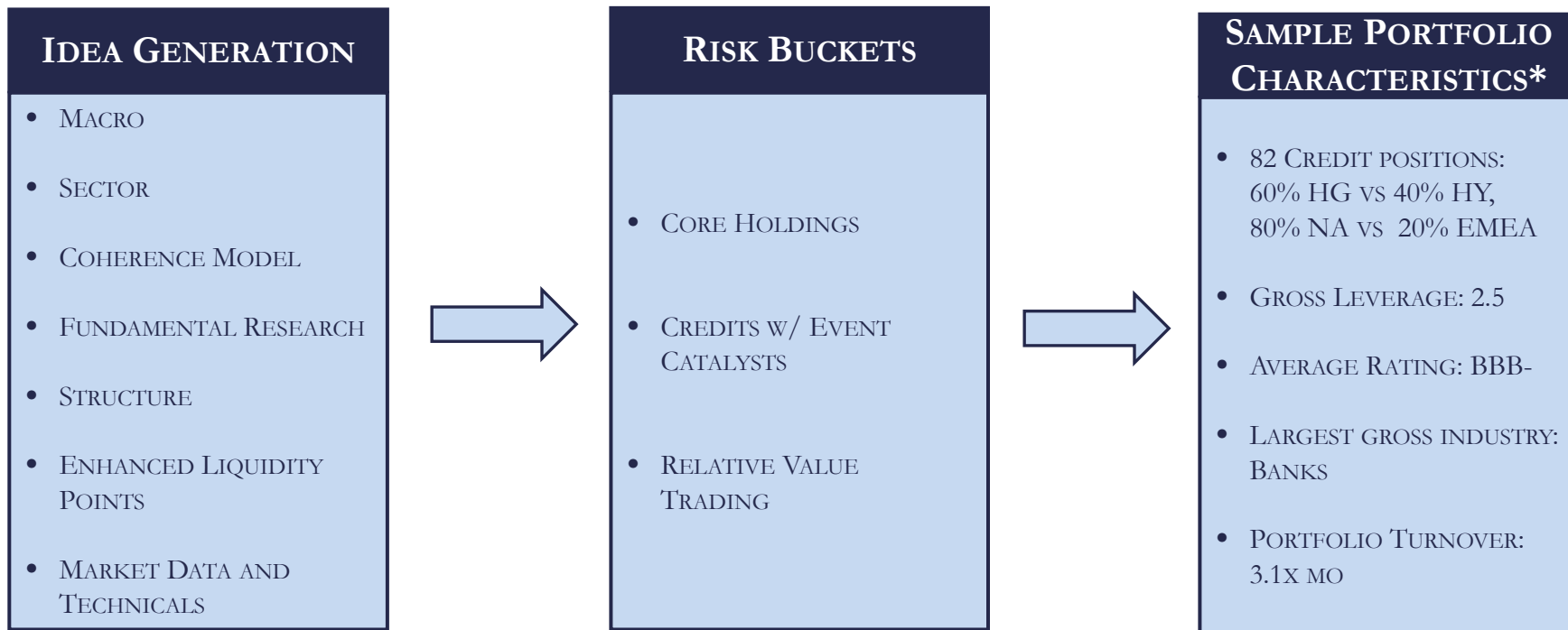
## Coherence Capital Partners: A Unique Approach to the Credit Markets

**Competitive Advantage:** The Fund employs a repeatable investment process with several key components

- **Equity Market Perspective**
  - We view the fixed income world as an extension of the equity markets.
- **Extensive Fixed Income Experience**
  - The team has worked together for decades, successfully navigating multiple credit cycles and interest rate environments.
- **Proprietary “Coherence Model”**
  - A cutting-edge proprietary model co-developed with IHS Markit LTD. The model output is combined with fundamental analysis.
- **Rigorous Risk Discipline**
  - The portfolio management team is extremely disciplined about loss mitigation and capital preservation.

**Alignment of Interests:** The management team has a substantial portion of their net worth invested in the Spectrum Fund, further aligning our interests with investors.

## Repeatable Investment Process



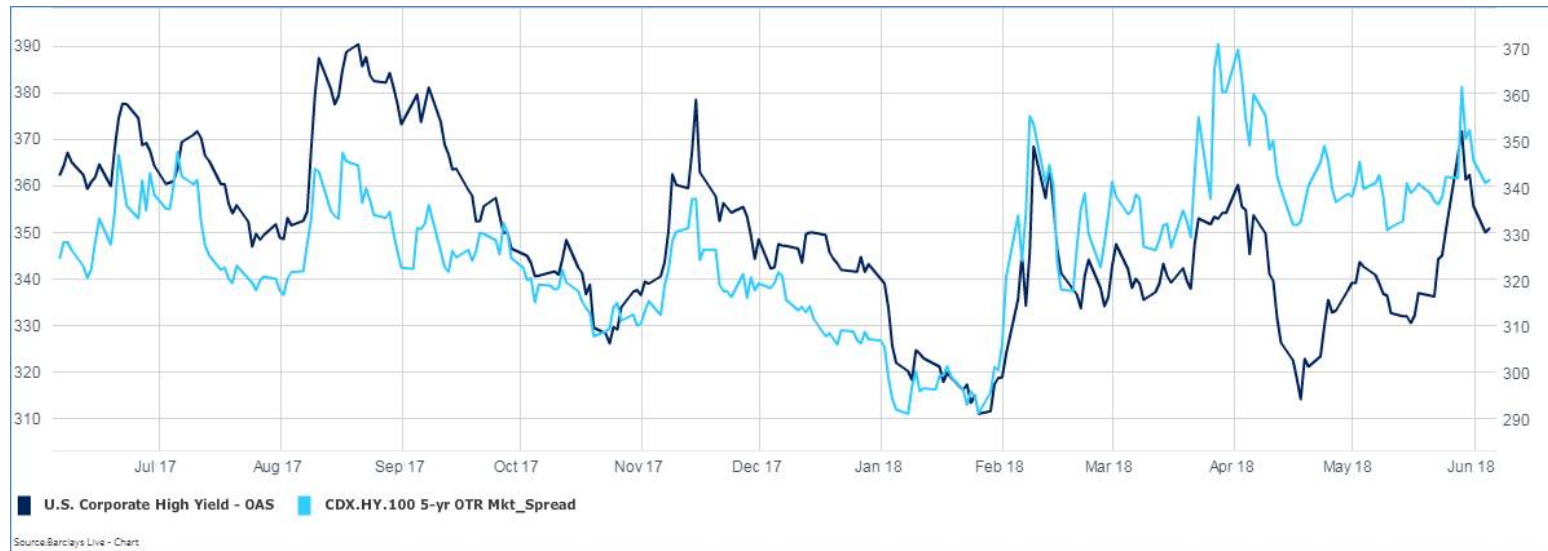
\* For illustration only.



## Start with a Macro View Because Timing Matters

- What is driving credit premiums?
  - Trade Wars – China, NAFTA
  - Korea
  - ECB – End of QE, balance sheet normalization
  - US Fed – Rate hikes, balance sheet normalization
  - Energy Prices – Extraction efficiency creates new dilemma
  - Euro Exit – UK, Italy, Spain
  - Expectations for global GDP growth led by US

## US HY OAS vs. US HY CDX in Spread



	Moody's			S&P		
	<u>Pos</u>	<u>Neg</u>	<u>Neither</u>	<u>Pos</u>	<u>Neg</u>	<u>Neither</u>
<b>HY</b>	7%	13%	80%	10%	12%	78%
<b>IG</b>	6%	14%	80%	6%	11%	83%



## Risk Factors in Credit Products

- Higher rates and larger risk premiums/wider spreads increases refinancing risk, increasing interest expense and extension risk.
- Good markets make bad bonds (covenant light). Higher rates and wider spreads will create credit dispersion.
- Flat default rates into 2019 and then gradually rising with negative credit rating momentum.
- Expansion of global credit - both corporate and personal - as world reflatates.
- M&A: Clear direction from government on what is allowable and what isn't, continued growth of both corporate credit and well as consumer credit.

## What Other Wholesaling Models Will Be “Amazoned”?

- American Tire – Goodyear and Michelin are now wholesalers.
- Auto Rentals – Technology, change in behavior and residuals weigh on sector.
- E&P Bonanza – Frackers, new technology, and a push to lower costs at the well head.
- Media Matrix – 5G changes the game for wirelines; is broadcasting dead as cord cutting increases, is content king, how will content be consumed?
- Grocers – Low margins are now enhanced by greater distribution and technology.
- Big Box – Becomes big hole for retailers and REITS.
- Security Firms – Will consumers manage their home networks?
- Travel – Technology and rewards programs have shifted behavior.
- Is Healthcare Next? – Healthcare is inherently inefficient, and technological innovation could drastically change how it’s delivered.



## Coherence Model Provides Insights

The Coherence Model uses AI and a multi-factor model to predict credit migration

- Helps us “punch above our weight”

Sector	Coherence Model Trend	Macro	Relative Value	Overweight	Underweight
Basic Materials	Positive	Neutral	Negative	USX (24)	BLL (28)
Consumer Cyclical	Negative	Negative	Negative	AMC (22), NUGGET	EXPE (82), GT (90), SBH, TSLA (71)
Consumer Non-Cyclical	Negative	Negative	Neutral		GIS (36), KR (87)
Energy	Positive	Neutral	Positive	ASCENT, CQP (22), DNR (6)	MEGCN (1)
Financials	Positive	Positive	Positive	MS (46), RBS (26)	DB (95), HSBC (88)
Healthcare	Positive	Negative	Neutral	HCA (7), VRXCN (39)	BMY (24), GILD (40)
Industrials	Positive	Positive	Neutral	CLOUD CRANE	ADT (53), F (46), GE (95)
Technology	Positive	Positive	Positive	MCHP (44), NXP (46)	QCOM (65), XRX
Telecom / Media	Negative	Neutral	Neutral	S (62), VIA (60)	CTL (83), TMUS (32)
Utilities	Positive	Negative	Neutral	AES(5)	CPN (90)





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