

## Private Credit Outlook

As we begin a new calendar year, we are reminded of the many unexpected challenges investors faced during 2022. The year was marked by a series of macroeconomic headwinds including, but not limited to, rising interest rates, inflationary pressures, oil price volatility, lingering supply chain constraints and increasing geopolitical risks with the ongoing conflict in Ukraine. These events will continue to shape investors' decisions during 2023, particularly as it relates to traditional fixed income investments – an asset class which until only recently has underperformed.

While investors today have many fixed income options, we believe private credit investments provide investors with a consistent performance profile across economic cycles given the unique characteristics of this asset class relative to traditional fixed income. More specifically, private credit investors may benefit from active management of each underlying investment, higher risk-adjusted returns, attractive cash-on-cash yield with low volatility and correlation with other asset classes. Although traditional fixed income investments have generated attractive returns over the past few quarters, historical returns have exhibited greater volatility, particularly in periods of economic uncertainty – it is this uncertainty that ultimately provides an even more compelling investment thesis for private credit within the current market environment.

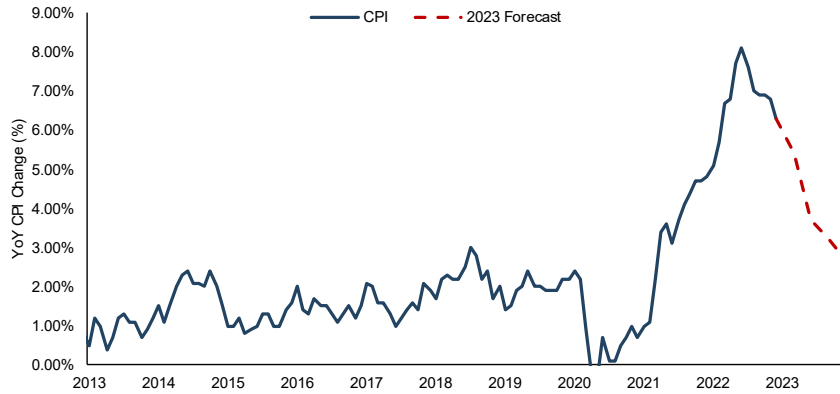
As we reflect on 2022 and the road ahead, we remain cognizant of the key macroeconomic themes that will influence our investment decisions:

### Inflation

After decades of relative stability, the recent surge in inflation, largely caused by supply chain constraints and demand-induced pressures, has reached levels not seen since the early 1980s, reaching a pinnacle of 8.1% in Canada during June 2022. In response, central banks moved quickly, tightening monetary policy in an effort to curb inflation. While the effects of higher interest rates are typically not picked-up in economic statistics for up to 18 months, we are now starting to see the Bank of Canada's ("BoC") desired impact. However, the impact of China's re-opened economy, accounting for ~18% of the global economy, remains unclear. As China's consumption increases, renewed upward pressure on commodities, energy, etc. seems inevitable.

While traditional fixed income strategies such as public bonds may be less attractive in periods of higher inflation due to their fixed principal and interest streams, non-traditional private credit strategies can benefit from floating rate coupons and shorter duration as well as tangible real asset collateral, whose value generally moves in-line with inflation, providing an effective inflation mitigant.

### Canadian CPI



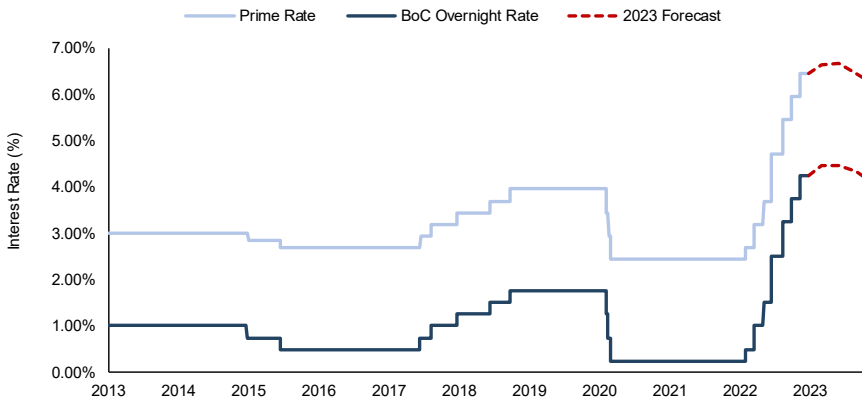
Source: Bloomberg

### Interest Rates

The BoC began tightening monetary policy in March 2022, increasing the overnight rate by an aggregate 425bps from a pandemic low of 0.25% to 4.50% as of January 2023. With short-term rates now reaching 20-year highs, both commercial and individual borrowers are starting to feel the impact of this tightening on their earnings and cash flow.

For the private credit investor, changes in interest rates not only impact risk-adjusted returns in absolute terms but should also be considered in assessing an underlying borrower's ability to make principal and interest payments. From a return perspective, with the vast majority of private credit being floating rate loans, a rising rate environment has augmented private credit returns. Furthermore, the use of floating rate 'floors' provides investors with downside return protection if/when interest rates begin to decline.

### Canadian Interest Rates



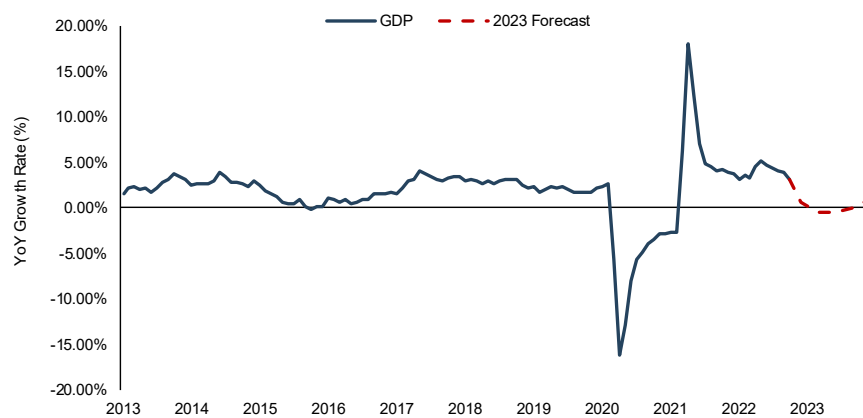
Source: Bloomberg

## Recession – A Hard or Soft Landing?

Despite the many headwinds during 2022, the economy remained resilient with GDP growth of 3.8%<sup>1</sup>. However, the viewpoint of professional forecasters place the probability of a recession over the next 4 quarters at over 40%<sup>2</sup>, with forecast 2023 GDP growth of 0.7%<sup>3</sup>. As consumers and businesses adjust to the impact of higher interest rates, some form of economic slowdown during 2023 is expected.

While we do not have a crystal ball nor are we taking a firm view of the outlook for the coming year, what we do know for certain is that 2023 will present new, and unexpected, challenges for the economy and investors. As a private credit investor, we are an active, not a passive, investor unlike the public bond market - this provides greater control in terms of when and how we invest, under what terms & conditions we invest, as well as the ability to drive change post-investment.

### Canadian Gross Domestic Product



Source: Bloomberg

## Fixed Income Alternatives

With market yields reaching their highest levels in several years<sup>4</sup>, and a recession to some degree expected during the current year, an argument could be made that bond returns will outperform during 2023. While the case for investing in bonds is potentially more compelling than it has been in several years, realizing meaningful returns from such a trade will depend on the timing and magnitude of monetary easing. Unlike the public bond market, private credit investments are generally of shorter duration with floating rates which allow an investor to participate in increases in risk-free rates while incorporating a 'floor' reference rate to provide downside return protection if risk-free rate rates fall mitigating investors' sensitivity, and returns, to adverse changes in interest rates. Thus, unlike a potential 'trade' opportunity with public bonds, private credit investments are structured to generate consistent risk-adjusted returns across economic cycles.

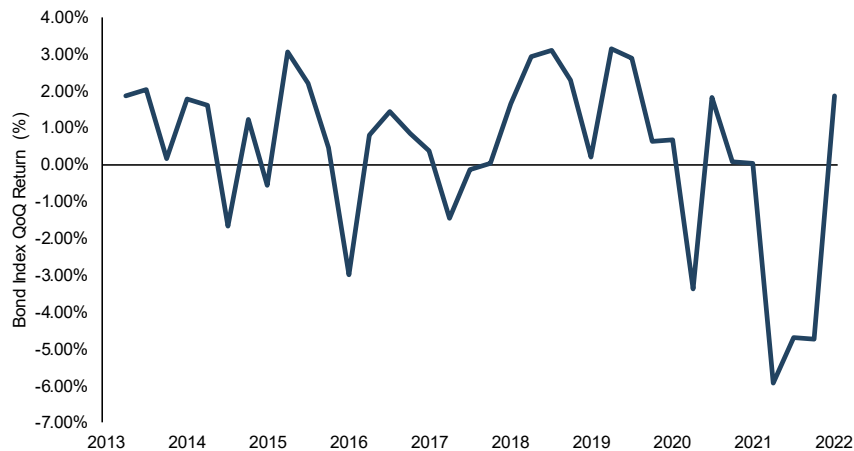
<sup>1</sup> Source: Statistics Canada

<sup>2</sup> Source: National Bank Financial Economics & Strategy

<sup>3</sup> Source: National Bank Financial

<sup>4</sup> Source: Bloomberg Data

### Barclay's US Aggregate QoQ Bond Returns



Source: Bloomberg

### Canadian Private Credit Market

Unlike investing in the public bond markets, there is not a concept of timing the market in private credit. There will always be a multitude of different macro-economic factors that will impact both the risk and return profile for any given investment – 2023 will be no different. With this in-mind, we will continue to focus on a broad range of both macro and idiosyncratic risks as we underwrite new investments and aim to construct 'all-weather' private credit portfolios.

Irrespective of the current & future economic climate, investors in Canada's private credit market may continue to benefit from:

- higher risk-adjusted returns compared to traditional investments;
- attractive cash-on-cash yield;
- low correlation with other asset classes;
- low NAV volatility; and,
- robust downside protection

The Canadian market continues to be a highly bespoke market in which the lender has the ability to customize structure, collateral and terms & conditions as well as adjust monitoring and oversight to meet investor risk tolerance and react in real-time to macroeconomic or firm-specific headwinds. Given the uncertain market outlook, such nimbleness and control will be key to driving outsized risk-adjusted returns during 2023.

Michael Scott, Managing Director, SAF Group. AGF and SAF Group have entered into an extended partnership that will focus on new private credit opportunities.

### AGF SAF Private Credit

Private credit is one of the fastest growing categories of alternative investments and investor demand continues to grow as investors seek reliable streams of income, diversification and attractive returns.<sup>1</sup> AGF SAF Private Credit provides access to a differentiated private credit strategy that aims to deliver attractive risk-adjusted returns with low correlation to traditional asset classes by allocating capital through various credit strategies to middle-market companies, primarily within Canada and the U.S. The strategy is available for institutional investors (AGF SAF Private Credit Limited Partnership) and retail investors (AGF SAF Private Credit Trust).

#### Partner:



SAF Group is one of Canada's leading alternative capital providers specializing in bespoke financial products. SAF's credit-focused team manage assets in capital intensive industries that are scalable across various industries. AGF and SAF have been partners in various capacities since 2014.

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Publication Date: February 23, 2023