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EVENT SUMMARY

Yield With Caution: Selectively Navigating Today's Credit Markets

In a recent fireside chat, we discussed how institutional investors should assess today's private and public credit markets. The backdrop for credit investing today is complex as nominal spreads widen underwriting standards tighten to levels greater than those reached during the global financial crisis, and a near $2.5 trillion in bonds and institutional loans are due to mature in the next year. These factors—along with liquidity and relative value considerations—are key considerations for investors seeking to capitalize on market dislocations. Below are key points shared by our expert panel during the discussion.

April 20, 2023

Saurabh Sud
Portfolio Manager
(T. Rowe Price)

Greg Leveto
Portfolio Manager
and Partner
(Oak Hill Advisors)

Oliver Fadly,
Principal, Head of Private
Debt Investments (NEPC)

Joe Nankof
Principal, Senior
Consultant (NEPC)

Current Private Market Investing Landscape

- Oliver Fadly, head of Private Debt Investments at NEPC, shared that most of it's institutional clients use direct lending as their first foray into a private credit allocation. Clients who have already made those allocations typically pursue more opportunistic strategies through a core-satellite approach. Opportunistic strategies have included asset-based lending or asset-based finance types of deals, for example, a late-stage venture lending opportunity related to the fallout of Silicon Valley Bank.
- Mr. Fadly shared that his firm has sought funds that are seeking to invest in companies that operate in overlooked parts of the market, are navigating supply and demand imbalances, or have challenges scaling liquidity. These are characteristics typically found in smaller companies.
- Often, companies facing these challenges have tapped out their lenders' credit facilities, and their equity holders also do not want to extend additional capital. Given the confluence of higher rates and reduced liquidity, such companies will require a capital infusion that takes a unique position in their capital structures. These scenarios create compelling opportunities for investment structures that resemble subordinated debt or private equity.
- Greg Leveto, portfolio manager and partner at OHA, referred to these opportunities as junior capital solutions. Companies that are solid candidates for these solutions are typically highly levered and sub-investment grade but are good businesses and offer meaningful spread. As banks continue to retreat from providing capital, investors can take advantage of these attractive opportunities.
- In real assets, OHA sees opportunities for investors to finance high-quality assets. Assets such as data centers with long-term contracts, renewable energy assets with real offtake agreements, and transportation assets with real counterparties are some examples of potential investments that are also less correlated with macroeconomic cycles.

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What should investors think of the approximately $1.5 trillion in capital raised over the last two years?

- Saurabh Sud portfolio manager of the T. Rowe Price Dynamic Credit Strategy[1], reminded guests to remain selective in public credit markets, citing unattractive spreads. He and his team are patiently searching for dislocations and considering relative value within sectors. For example, in the recent banking crisis related volatility, his team was buying strong regional bank credits, Investment Grade rated REIT bonds, dislocated European AT1 paper of strong bank credits and finally, low dollar high yield and Bank Loans where there is a high probability of an early call. The need to be patient and allocate resources to such opportunities when they present themselves – such as in March 2022, October 2022 and March 2023 – is as important as ever.
- From a macro perspective, Mr. Sud feels that a bearish case for credit needs one or more catalysts, which he believes could manifest in the second half of 2023 and present an attractive entry point for both public and private credit investors. He cited four potential catalysts:
  1. **Fed to likely over-tighten.** The Fed's fear of inflation stems from the 1970s, when it lost substantial credibility. It's evaluation framework consists of backward-looking indicators, such as personal consumption expenditures inflation, unemployment, and labor force participation. Using these lagging data points when the economy is slowing in real time elevates the potential for over-tightening.
  2. **Debt ceiling worry and real U.S defaults.** This is seen in spreads, but Mr. Sud believes that it is a sideshow. More important is that when that gets resolved (and we believe it will—the Treasury General Account, which has been a tailwind for liquidity and for risk assets, has been coming down), mechanically it starts moving higher due to Treasury bill issuance. That will put pressure on reserves, which will put pressure on bank deposits. What we saw is March is potentially not over. More supply will suck liquidity out of the system, which would mean that reserves will actually go down. And so that is a very important aspect of when the debt ceiling gets resolved, as opposed to being worried about what the U.S. will or will not default on.
  3. **Earnings recession looming.** Company revenues and earnings are reported nominally, so an earnings recession was delayed due to elevated price levels, and Mr. Sud believes that base effects will be quite challenging going forward.
  4. **Credit standards tightening because of the regional bank crisis.** Banks were already tightening lending standards last year. Default mistakes are more costly than reaching for incremental yield; as such, Mr. Sud believes underwriting standards will continue to become more scrupulous, which may create a more challenging environment for credit risk beginning in the third quarter.

What is the case for asset-based finance?

- When considering an allocation to asset-based finance strategies, Mr. Leveto cited these strategies' different correlations to macroeconomic pressures, such as inflation, bank liquidity, and interest rates.
- In the near term, investors have the ability to mitigate those highly correlated areas and mitigate macro pressures with asset-based investments. The valuation of the asset might move because discount rates are moving around, but as a credit provider, you may earn a high-single-digit or low-double-digit return likely with lower volatility.
- It is early in the cycle for asset-based finance, specifically what sits on banks' balance sheets. Research suggests that 55% of all commercial real estate lending in the United States has been provided by banks in the last 10 years.

The commercial real estate market is showing signs of real cracks

- We have been underweight or short the CMBS market over the last six to nine months. When the headlines started appearing in the last few weeks, we actually were covering it, but now we don't see a fundamental reason to change our view. The underperformance relative to the high yield market has been very dramatic, and from a relative value perspective, it stands out. The worry is for real, but the problem is that there's a lot of noise that goes on in this market, so investors don't actually realize losses. When the CMBX BBB- tranches are trading at 70 cents to the dollar, short investors need to realize the default losses immediately to realize gains or that it will happen very soon—and that is unlikely to happen, in our perspective.
- We are not favorable on the sector or its sector outlook on an asset valuation basis because if asset valuations keep declining, the Loan to Value on many bonds will keep trending higher and spreads will likely keep going wider.
- Investors can find select assets, which are really attractive office assets that you would buy with your own money, and those kind of assets you can underwrite. Their spreads have widened and are attractive in selective situations, but it is very tough to make a call on the overall sector. We are evaluating credits on a fundamental basis as opposed to taking a big credit view on the sector.

[1] In Canada, the Dynamic Credit Strategy is advertised and marketed as the Unconstrained Credit Strategy.

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