Alternative Credit: 1Q22 Review

Persistently high inflation readings and the prospect of more restrictive monetary policy drove Treasury yields higher across the curve during the first quarter, pressuring fixed income in general and duration-sensitive assets more specifically.

In the leveraged credit space, first quarter dynamics resulted in a bifurcation of performance between floating-rate loans and fixed-rate bonds, with the Credit Suisse Leveraged Loan Index returning -0.1% on a total-return basis compared to the -4.8% performance of the Bloomberg US High Yield Index. Investment grade paper fared even more poorly, with the Bloomberg US Aggregate and Global Aggregate indexes returning -5.9% and -6.2%, respectively.[1]

Beyond relative performance, the appeal of assets with short duration profiles and advantaged positions in the capital structure was evident in first quarter retail mutual fund flow data. Bank loan strategies attracted nearly $20 billion, the greatest inflows by far in a fixed income complex that saw outflows in aggregate. In contrast, high yield strategies were the biggest loser, dropping close to $29 billion.[2]

KEY TAKEAWAYS

- While fixed income in general has struggled in the face of rising interest rates, floating-rate assets like broadly syndicated loans and direct lending historically have demonstrated resilience.
- Loan issuance lagged in the first quarter, due in part to softness in demand for collateralized loan obligations. This was offset to some degree by strong flows into loan funds.[3]
- Interest coverage may represent a potential hazard to watch in the loan market going forward, as the rally in loan reference rates means that a number of borrowers face higher debt-servicing costs.
- Direct lending activity also was down, not surprising given seasonality and the public market volatility that emerged during the period.[4] Given vast amounts of private equity dry powder, deal flow, in our view, seems unlikely to remain subdued for long.
- Market complications that we expected to emerge in the second half of 2022 may have been pulled forward by the impacts of Russia's invasion of Ukraine. We believe deep credit analysis is of particular value in nuanced markets like today's.

Views expressed are as of April 21, 2022.

1. Source: FactSet; data as of March 31, 2022.
2. Source: YCharts: data as of March 31, 2022.
3. Source: LCD, an offering of S&P Global Market Intelligence; data as of March 31, 2022.
4. Source: Cliffwater LLC; data as of March 31, 2022.

Floating-Rate Assets Historically Have Been Resilient in the Face of Uncertainty

With inflation surging to highs not seen since the early 1980s and showing no signs of abating, markets have spent the past several months calibrating their expectations of central bank policy response, sending Treasury yields steadily higher in the process. In March, the Federal Reserve set its inflation-fighting efforts into motion, enacting a 25 basis point hike to its benchmark rate—the first in more than three years—and signaling that six more of that magnitude were likely over the balance of the year. Minutes from that meeting suggested that even more aggressive action is possible, however, and futures markets now are pricing in an additional 250 basis points of tightening this year, including hikes of 50 basis points at the next two Fed meetings.[5] The central bank also is finalizing a plan to pare back its $9 trillion balance sheet by letting up to $95 billion of maturing securities run off monthly, further reducing liquidity in the financial system.[6]

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While the full economic impact of a less-accommodative Fed will take some time to play out, US GDP growth in the first quarter likely slowed from the 7.0% rate posted in fourth quarter 2021. The Atlanta Fed's GDPNow forecast is for 1.3% growth for first quarter, as strong household balance sheets and a tight job market are expected to bolster consumer spending in the face of multi-decade-high inflation to offset the drag of inventory investment and net exports.[7] The sustainability of the consumer is in question, however; the latest consumer sentiment index from the University of Michigan came in at the lowest level since 2011, with respondents pessimistic that inflation pressures will ease substantially over the next year.[8] With prices at the grocery store and gas pump climbing at rates in excess of the official inflation number, it's hard to see consumers continuing to spend blithely as their purchasing power wanes.

Businesses, too, have reason to be concerned about inflation, as evidenced by the substance of January's quarterly conference calls; 356 of S&P 500 Index companies cited the negative impacts of higher input prices, the highest number in at least 10 years. And while revenue growth is expected to remain buoyant as companies pass along most of their higher input costs by raising prices, analysts expect profit margins to contract for a third straight quarter.[9] Generally speaking, inflation historically has been positive for credit over the short to medium term—if the issuer has pricing power to absorb higher input and labor costs. Given the diversity of the credit market, a bit of separation may emerge among business models and across industries, presenting opportunities to identify those companies seemingly more likely to weather higher costs and thus maintain revenues, earnings and margins.

Despite the gathering headwinds, credit fundamentals remained largely supportive in the first quarter. Credit quality in the loan market was stable, leverage was elevated but well off its 2020 highs, and measures of market distress remain very low. Ratings upgrades continued to exceed downgrades, though the pace has slowed considerably.[10]

While it remains ample currently, interest coverage may represent a potential hazard to watch for in the loan market. The recent rally in loan reference rates, including Libor and the secured overnight funding rate (SOFR), has pushed many outstanding loans above their contractual interest rate floors, meaning that a number of borrowers will now face higher debt-servicing costs at a time when commodity and labor costs are rising and economic growth may be slowing. Lower-rated companies already struggling to generate cash may find themselves slipping into a cash-flow negative position and facing the threat of downgrade.

Seasonality, Volatility Weigh on Market Technicals

After setting a new annual high-water mark in 2021, leveraged loan issuance got off to a strong start to 2022, posting its second-best January on record.[11] The pace faded sharply over the balance of the quarter, however, as Russia's invasion of Ukraine pumped additional geopolitical uncertainty into a market already beset by concerns around inflationary pressures and the potential impact of tightening financial conditions on economic growth.

Similarly, the formation of collateralized loan obligations (CLOs) lagged the pace of recent quarters after a record-setting 2021. Demand for loans historically has been driven by a combination of CLO formation and retail mutual funds, with the former typically the much larger contributor. Institutional investors—often insurance companies, mutual funds, and banks and other financial institutions—are the primary investors in CLOs. As yields backed

5. Source: CME FedWatch Tool; data as of April 19, 2022.
6. Source: *The Wall Street Journal*; as of April 6, 2022.
7. Source: Federal Reserve Bank of Atlanta; data as of April 19, 2022.
8. Source: University of Michigan; data as of March 31, 2022.
9. Source: FactSet; data as of April 14, 2022.
10. Source: LCD, an offering of S&P Global Market Intelligence; data as of March 31, 2022.
11. Source: LCD, an offering of S&P Global Market Intelligence; data as of March 31, 2022.

up across traditional fixed income asset classes during the quarter and the CLO spread advantage relative to other paper contracted, some institutions were presented with a wider selection of high-quality investment options with the potential for attractive total returns, including those that lack the complexity of CLO investment. Foreign demand for CLOs has been further dampened by the steady rise in dollar-hedging costs this year. The softness in CLO demand for loans was offset somewhat by continued strong flows in loan mutual funds, as retail investors continued to recognize the potential benefits of floating-rate securities in a rising-rate environment.

> New loan issuance and direct lending activity in the first quarter lagged last year's record pace.

Another fly in the ointment for leveraged loan and CLO issuance has been the need, as of January 1, to price CLOs off of SOFR rather than traditional USD Libor. Longstanding concerns about the subjectivity of Libor—which is calculated according to participant banks' reporting on overnight rates—prompted policymakers to mandate the use of a more robust reference rate. As a broad measure of the costs of borrowing cash overnight collateralized by US Treasuries, SOFR is based on actual repo-market transactions and considered nearly risk-free; Libor, in contrast, is essentially hypothetical and incorporates bank credit risk given that it is unsecured.[12] As a result, SOFR tends to be lower than the Libor equivalent, though the spread between the two varies over time. This spread inspired a late-2021 rush among institutional buyers—and banks, in particular— eager to load up on Libor-based loans before new issuance ceased.

Direct-lending activity also was down in the first quarter, as the private equity deals that fuel borrowing lagged last year's pace; Cliffwater LLC estimates that 75% of direct loans are extended to companies with private equity backers.[13] This is not unexpected; first quarter is typically a slower period in this space, and the kind of public market volatility we've seen year to date tends to encourage caution among borrowers and lenders. Given the $1.8 trillion in global private equity dry powder seeking investment, deal flow appears unlikely to remain subdued for long, barring any unforeseen market dislocation, which should provide ample opportunity for direct lenders to put money to work.[14]

Conclusion

We entered 2022 expecting some carryover of 2021's positive momentum in terms of credit fundamentals, with complications potentially emerging in the second half of the year. It seems Russia's incursion into Ukraine—and its attendant impacts on supply chains, raw materials prices, inflation levels and central bank policy, not to mention the wide range of potentially adverse geopolitical outcomes it introduced—may have accelerated this timeline. However, it also reinforced our belief in the strategic value of deep, laborious credit analysis at both the initial underwriting stage and on an ongoing basis as part of a rigorous and disciplined portfolio management process.

12. Source: Federal Reserve Bank of New York; as of August 27, 2021.
13. Source: Cliffwater LLC; data as of March 31, 2022.
14. Source: Preqin; data as of February 28, 2022.

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Past performance does not guarantee future returns.

A **collateralized loan obligation (CLO)** is a single security backed by a pool of debt.

A **senior bank loan** is a corporate loan repackaged into a bundle of corporate loans that is sold to investors. These loans typically come with floating interest rates and are secured via a lien against the assets of the borrower. Senior bank loans take priority (seniority) over all of the other debt obligations of a borrower.

Credit Suisse Leveraged Loan Index is designed to mirror the investable universe of the US dollar-denominated leveraged loan market. The index inception is January 1992. The index frequency is daily, weekly, and monthly.

Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from 24 local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

Bloomberg US Aggregate Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, fixed-rate agency MBS, ABS and CMBS (agency and non-agency).

Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

Libor (the London interbank offered rate) historically has been the principal floating-rate benchmark in the financial markets. However, as a result of longstanding regulatory initiatives, Libor is being discontinued. Its discontinuation has affected and will continue to affect the financial markets generally and may also affect the Fund's operations, finances and investments specifically. The date of discontinuation will vary depending on the Libor currency and tenor. In March 2021, the UK Financial Conduct Authority (FCA), which is the regulator of the Libor administrator, announced that Libor settings will cease to be provided by any administrator or will no longer be representative after specified dates, which will be June 30, 2023, in the case of the principal US dollar Libor tenors (overnight and one, three, six and 12 month), and December 31, 2021, in all other cases (i.e., one week and two month US dollar Libor and all tenors of non-US dollar Libor). Thus, certain Libor contracts have transitioned to another benchmark as of December 31, 2021, and other existing Libor contracts will transition to another benchmark after June 30, 2023. An adjusted-term **SOFR (secured overnight financing rate)** has become the market-prevalent replacement reference rate. There is no assurance that SOFR-based rates, as modified by an applicable spread adjustment, will be the economic equivalent of US dollar Libor. SOFR-based rates will differ from US dollar Libor, and the differences may be material. As a result of the Libor discontinuation, interest rates on financial instruments tied to LIBOR rates, as well as the revenue and expenses associated with those financial instruments, may be adversely affected.

Indices are unmanaged and do not incur management fees or other operating expenses. One cannot invest directly in an index.

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- Volatility of returns;
- Interest rate risk;
- Restrictions on transferring interests in a private investment strategy;
- Potential lack of diversification and resulting higher risk due to concentration within one of more sectors, industries, countries or regions;
- Absence of information regarding valuations and pricing;
- Complex tax structures and delays in tax reporting;
- Less regulation and higher fees than mutual funds;
- Use of leverage, which magnifies the potential for gain or loss on amounts invested and is generally considered a speculative investment technique and increases the risks associated with investing in the strategy;
- Carried interest, which may cause the strategy to make more speculative, higher risk investments that would be the case in absence of such arrangements; and
- Below-investment-grade loans, which may default and adversely affect returns.

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