Alternative Credit: 2Q22 Review

For traditional fixed income markets, the second quarter of 2022 was not unlike the first.

Financial conditions continued to tighten during the period as aggressive anti-inflation rhetoric from the Federal Reserve turned into policy action, driving Treasury yields higher across the curve and pressuring bonds in general and duration-sensitive assets especially. The Bloomberg US Aggregate Index fell again, losing 4.7%, and is on track to post consecutive annual declines for the first time since its inception in 1976.[1]

While floating-rate debt remained relatively resilient, recent months saw the broad weakness across markets begin to seep into this space as well. The Credit Suisse Leveraged Loan Index delivered a total return of -4.6% for the second quarter, comparing favorably to the -9.8% performance of the Bloomberg US High Yield Index but a marked deterioration from its flattish first quarter.

Though inflation and tighter financial conditions are starting to weigh on borrowers, credit fundamentals have remained mostly supportive, for now. Loan issuance, in contrast, has been battered by higher rates and volatility, as well as increased competition from more traditional debt investments. In such an environment, we are putting money to work selectively with an eye toward the long term.

KEY TAKEAWAYS

- Despite growing concerns about the trajectory of the economy, credit fundamentals have remained mostly supportive. Market technicals, on the other hand, have weakened markedly.
- At current prices, the loan market appears to be pricing in a mild recession but not a "hard landing." Given considerable volatility, this could change rapidly—for better or worse.
- The rapid increase in rates at the short end of the yield curve and generally wider spreads for higher-quality credits gives institutional investors a greater range of investment options and has been a headwind for the formation of collateralized loan obligations.
- At First Eagle Alternative Credit, we leverage decades of credit experience in search of borrowers and market sectors best positioned to ride out an environment that may get worse before it gets better.

Views expressed are as of July 28, 2022.

1. Source: FactSet; data as of June 30, 2022.

Credit Fundamentals Generally Remain Supportive...

With inflation showing few signs of abating from current multi-decade highs, Federal Reserve rhetoric and action appears focused on achieving price stability before elevated inflation levels become anchored in the national psyche. March's 25 basis point hike moved the federal funds rate off the zero lower bound for the first time in nearly two years, and the Fed grew more forceful in the second quarter. It raised rates 50 basis points in May and another 75 basis points in June, and futures markets are pricing in a minimum 75 basis points of additional tightening in July, with 100 basis points a possibility.[2] As a complement to these rate hikes, the Fed in June began the process of quantitative tightening by letting maturing securities run off its balance sheet.

> The loan market's current average bid implies a mild recession and some deterioration in credit fundamentals, but not a hard landing.

This effort comes with no small risk, as past attempts to engineer a "soft landing" of the economy have shown. Indeed, toward the end of the second quarter and into the beginning of the third, tighter financial conditions appeared to inspire fear not just of an inflation-dampening economic deceleration but of a full-fledged recession. We have begun to see signs that fiscal tightening and higher interest rates are causing demand to soften; in the US, for example, consumer sentiment has deteriorated, manufacturing activity is slowing and mortgage applications are down.[3]

The impact of recessionary concerns was most evident in the bond markets. After climbing near 3.5% by mid-June—from close to 1.5% to start 2022—the 10-year US Treasury finished the first half of the year near 3.0%, a rally that suggests to us that markets expect central bank policy restraint to come to a premature end in the face of withering economic growth.[4] Meanwhile, the yield curve inverted briefly twice during the second quarter and has entered into a lengthier negative position in early July; such inversions have long been regarded as a potential harbinger of recession.[5]

Despite all the noise, loan fundamentals have remained generally solid. Borrower revenues and earnings have held up thus far, and interest coverage has been strong even as leverage inched back up to 2020 levels after easing somewhat in 2021. The loan market's default rate, a lagging indicator, remains near all-time lows, though the distress ratio, a forward indicator, climbed as the bid price on more performing loans fell below 80 cents on the dollar. Though loan downgrades in June exceeded upgrades for the first time in 16 months, the market's overall credit quality continues to be strong. At 3.5%, the index's share of paper rated C or lower is well shy of the post-global financial crisis average of 6.4%. Only one notch higher, however, the B- cohort stands at a record 28% of the index, suggesting the market's rating composition could shift quickly.[6]

While it's not hard to imagine some fundamental deterioration going forward in light of broad macroeconomic trends, the market appears to be pricing much of this in. At about 91 cents on the dollar, the loan market's current average bid implies a mild recession and some deterioration in credit fundamentals, but not a hard landing. For context, the market traded as low as 65 cents during the global financial crisis and 80 cents during the worst of Covid.

...Even as Support from Market Technicals Weakens

Though leveraged loan issuance followed up its record-setting 2021 with a strong January 2022, it's been all downhill from there. During the second quarter, acute recession fears were added to a roster of headwinds that already featured inflation, supply-chain disruptions, war between Ukraine and Russia, rising interest rates and escalating funding costs. Total US institutional loan volume in the US fell to about $55 billion during the period, its lowest level since the onset of Covid-19 brought the market to a near standstill two years ago.[7] The deals that have been getting done have typically been larger packages essential to the completion of a merger or acquisition (M&A)—though these have been priced at steep discounts to par, absorbed by the underwriting banks.

Collateralized loan obligation (CLO) formation followed a similar downtrend. Demand for loans historically has been driven by a combination of CLO formation and retail 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. With yields across traditional fixed income asset classes continuing to back up while CLO spread premia tightened, institutional buyers of

2. Source: CME Group; data as of July 14, 2022.
3. Source: Bureau of Labor Statistics, Institute for Supply Management, Mortgage Bankers Association; data as of June 30, 2022.
4. Source: Bloomberg; data as of June 30, 2022.
5. Source: Bloomberg; data as of July 15, 2022.
6. Source: Leveraged Commentary & Data; data as of June 30, 2022.
7. Source: Leveraged Commentary & Data; data as of June 30, 2022.

these vehicles have with multiple high-quality alternatives to CLO investment, many of which entail considerably less complexity. In addition, CLO demand from foreign institutions has been further hampered by steadily rising dollar-hedging costs.

While not a lot of CLO new issuance is happening, these vehicles tend to be treated as buy-and-hold investments by institutions. This has mitigated some of the selling pressures we've seen in the mutual fund space, where flows turned negative in the second quarter after providing more than a year of positive support for loan market technicals.

The direct lending market appears somewhat complacent currently. In our experience, activity in this space tends to react to broader market trends with a lag of 30 days or so, but we've yet to see that in 2022. Unlike the loan market, private credit issuance has improved after a first quarter slowdown, and we're even seeing signs of more borrower-friendly structures. And though activity is off 2021's record pace, demand for direct lending opportunities continues to far outstrip supply given nearly $400 billion of undeployed capital in private credit vehicles. With $1.3 trillion in private equity dry powder waiting to be put to work, current complacent attitudes have the potential to persist.[8]

Conclusion

We entered 2022 expecting loan markets to reflect 2021's buoyant attitudes for some period of time before entering into a more problematic state later in the year. However, while conditions certainly have grown more complicated for lenders and investors, all is not doom and gloom. Though the exact number is opaque, a number of borrowers in the loan universe use credit derivatives or rate caps to hedge the interest rate risk of their balance sheets; depending on the characteristics of the hedge, this may provide a buffer against rising market rates for some period of time (typically 60–90 days but potentially as much as 270 days). Further, the risk of a loan "maturity wall" seems low given the access to liquidity that characterized the past couple of years, which should help mitigate defaults over the next few years.

> We believe now may be a good time to put money to work in the alternative credit space with an eye toward the long term.

For those with a multiyear investment horizon and a patient, selective approach, we believe now may be a good time to put money to work in the alternative credit space. As noted earlier, the broadly syndicated loan market as a whole is trading at a discount that suggests a mild recession; deeper bargains are likely to emerge should the economic picture worsen. That said, attempts at market timing are unlikely to produce favorable results. Instead, we look to deep credit analysis to identify borrowers and sectors we believe may prove resilient in what could be a prolonged period of uncertainty. While our underwriting is unlikely to immunize us from the issues currently bedeviling markets broadly, we expect it could mitigate the impacts over the long term.

8. Source: Preqin; data as of June 30, 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.

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

Risk Disclosures

All investments involve the risk of loss of principal.

Alternative investments can be speculative and are not suitable for all investors. Investing in alternative investments is only intended for experienced and sophisticated investors who are willing and able to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks include:

- Loss of all or a substantial portion of the investment;
- Lack of liquidity in that there may be no secondary market or interest in the strategy and none is expected to develop;
- 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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