First Eagle Alternative Credit: 3Q22 Review

The early-summer rebound in risk assets broadly proved short-lived, and an August whipsaw in sentiment reintroduced the market weakness that has characterized much of 2022.

After an initial pullback, interest rates continued to climb across the third quarter—the US 10-year Treasury finished September at around 3.83%, about 80 basis points higher than it ended the second—and duration-sensitive investments bore the brunt of the selloff. The Bloomberg US Aggregate Bond Index lost 4.8%, bringing its year-to-date return to -14.6% and improving the odds that it will post consecutive annual declines for the first time since its 1976 inception.[1]

Within leveraged credit, relative performance behaved more or less as we would expect given the background of rising interest rates and weakening economic activity, and instruments with less duration and higher credit quality generally outperformed. The broadly syndicated loan market, as reflected by the Credit Suisse Leveraged Loan Index, delivered a total return of 1.2%, with performance deteriorating as down the ratings spectrum.[2] The Bloomberg US Corporate High Yield Index, in contrast, lost 0.6%.[3]

KEY TAKEAWAYS

- Despite elevated inflation levels and slowing economic activity, leveraged loan fundamentals remain generally supportive, in our view, due in part to the strong financial condition in which most borrowers entered this downturn.
- Interest coverage remains ample at the index level, but we're starting to see differentiation across industries and among individual borrowers as evinced through rising distress ratios.
- While loan issuance and demand have both fallen sharply, a large volume of undeployed capital in private credit vehicles has supported the direct lending market and helped keep prices stable.
- Conditions like those we're currently experiencing can be challenging. Historically, however, they often have created opportunities for active managers with a patient, selective approach and a commitment to rigorous underwriting.

1. Source: FactSet; data as of September 30, 2022.
2. Source: Bloomberg; September 30, 2022.
3. Source: Bloomberg; September 30, 2022.

Fundamentals Generally Resilient, but Strains Emerging

Hopes that economic stagnation would compel the Federal Reserve to moderate its pace of rate hikes—and the risk rally these hopes inspired—were dashed in late August, as central bank rhetoric underscored its commitment to fighting inflation. At late August's Jackson Hole Economic Symposium, for example, Fed Chair Powell noted that the restoration of price stability remained the Fed's primary focus, saying that "pain to households and businesses" were "the unfortunate costs of reducing inflation." His tough talk was followed up by tough action, as the central bank announced another 75 basis point hike to the federal funds rate at its September meeting. The Fed's third consecutive hike of that magnitude—and fifth consecutive overall—brought the benchmark rate to 3.25%, and the "dot plot" of committee member forecasts implies it will comfortably exceed 4% by year-end.[4] Other major central banks, including the European Central Bank and the Bank of England, have also raised benchmark rates.

> Despite elevated inflation levels and slowing economic activity, leveraged loan market fundamentals remain generally supportive.

Though inflation in the US continues to be troublingly high—September core CPI came in at a new 40-year high—anchored long-term inflation expectations suggest the Fed's credibility remains intact.[5] Economic contraction in the first and second quarters of 2022 had some observers declaring recession, but the National Bureau of Economic Research considers a broader range of indicators in its capacity as official arbiter of such matters and has yet to declare a peak to the current expansion. And while the yield curve has been inverted since early July, a traditional harbinger of recession, ongoing strong job growth and low unemployment appear to be inconsistent with a recessionary environment, as does positive growth in gross domestic income.

Despite elevated inflation levels and slowing economic activity, leveraged loan market fundamentals remain generally supportive, in our view. Part of this is due our view that the loan market entered this transition well-positioned in a number of ways. The vast majority of borrowers refinanced debt at low rates in recent years, and a minimal amount of paper coming due this year and next. Further, some borrowers likely employed derivatives techniques like hedges and swaps to mitigate the impact of rising rates and extend the maturity of their debt loads.

Weighted average leverage is fairly high, but interest coverage remains ample even after pulling back from early-2022 levels. This number can shift quickly and dramatically as rates rise, however, and there can be significant differentiation across industries and among individual borrowers. Those with pricing power and the ability to pass along higher costs onto their customers will be better positioned to defend EBITDA levels and margins, as will companies with reasonable inventory levels.

We've seen the emergence of idiosyncratic separation during the challenging conditions of the third quarter. Loan defaults by volume—a backward-looking indicator—came in at the highest quarterly level since the pandemic-impacted second quarter of 2020. The distress ratio—a forward-looking indicator that reflects loans trading for less than 80 cents on the dollar—also hit near-term highs, with internet & direct marketing retail and household durables sectors leading the way.[6] That said, the current average bid for the loan market as a whole remains at about 91 cents on the dollar, which 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.

4. Source: Federal Reserve; data as of September 30, 2022.
5. Source: Bloomberg; data as of September 30, 2022.
6. Source: PitchBook, Leveraged Commentary & Data (LCD); data as of September 30, 2022.

Both Supply and Demand Have Waned

Total US institutional loan volume fell to about $24 billion during the period, the lowest since 2010; the current level represents a rapid decline from volume of $61 billion in the second quarter of this year and $120 billion in the first. Excluding refinancing activity, third quarter issuance was the lowest it has been since 2009.[7]

Demand for loans—historically has been driven by a combination of CLO formation and retail funds, with the former typically the much larger contributor—also has declined. With yields across traditional fixed income asset classes continuing to back up while CLO spread premia tightened, institutional buyers of 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. Despite these headwinds, CLO formation appears to be running at a pretty consistent rate in 2022, even if levels are considerably below 2021. In contrast, mutual fund flows have been consistently negative this year. After 17 consecutive months of inflows, loan funds have now lost assets or five straight months as retail investors grow increasingly concerned about recession and the Fed approaches its perceived terminal rate.[8]

> Interest rate volatility has weighed on both loan supply and demand.

The direct lending market continues to appear somewhat complacent due in part to a significant imbalance between the availability of direct lending opportunities and the $400 billion or so of undeployed capital in private credit vehicles. [9] With pricing relatively stable, private equity sponsors have been able to seek lower costs of capital and/or expand their existing facilities.

Conclusion

All told, leveraged credit markets have responded rationally to the investment backdrop, in our view, and market functionality has remained intact despite the significant uptick in volatility. While the conditions that we've seen in 2022 can be challenging for investors to stomach, such an environment tends to present opportunities for active managers with a patient, selective approach and a commitment to rigorous underwriting.

For example, our credit work has pointed us to certain areas of the market—notably in loans rated B-/B3—where the marginal demand from CLOs has faded alongside reduced formation. With the natural CLO buyers of such paper demonstrating less interest, we've seen loans from what we view as resilient issuers trading at attractive discounts to par and offering the potential for compelling total returns. With the illiquidity premium of the direct lending space fading as the broadly syndicated loan market has begun to reprice, our portfolio's relative allocation has drifted in favor of the latter. That said, as opportunities emerge in direct lending we'll likely move closer to long-term average targets within our opportunity set.

7. Source: JPMorgan; data as of September 30, 2022.
8. Source: JPMorgan, Lipper FMI; data as of September 30, 2022.
9. Source: Preqin; data as of June 30, 2022.

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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.

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.

Bloomberg US Long Treasury Index includes fixed income securities issued by the US Treasury (not including inflation-protected bonds) and US government agencies and instrumentalities, as well as corporate or dollar-denominated foreign debt guaranteed by the US government, with maturities greater than 10 years.

Consumer Price Index for All Urban Consumers (CPI-U) measures the changes in the price of a basket of goods and services purchased by urban consumers.

Core Consumer Price Index (CPI) measures the changes in the price of a basket of goods and services, excluding food and energy, purchased by urban consumers.

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.

MSCI World Index is a widely followed, unmanaged group of stocks from 23 developed markets and is not available for purchase. The index provides total returns in US dollars with net dividends reinvested.

S&P 500 Index is a widely recognized unmanaged index including a representative sample of 500 leading companies in leading sectors of the US economy and is not available for purchase. Although the S&P 500 Index focuses on the large-cap segment of the market, with approximately 80% coverage of US equities, it is also considered a proxy for the total market.

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.

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

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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