



Alternative Credit: 2Q23 Review

With March's bank failures seemingly contained, markets refocused their attention on the hawkish rhetoric coming from the Federal Reserve.

The resulting rise in interest rates during the second quarter, combined with a dearth of new-loan supply, continued to be supportive of the leveraged loan market, which is on track for its best year since the global financial crisis. The Credit Suisse Leveraged Loan Index delivered a total return of 3.1% for the quarter, while the Bloomberg US Corporate High Yield Index was up 1.7% and the Bloomberg US Aggregate Bond Index fell -0.8%.¹

As it was last quarter, uncertainty was the primary driver of second quarter activity in the leveraged credit markets. Without greater certainty around a range of issues—monetary policy and the tug of war between recession and inflation perhaps chief among them—it's difficult to see a significant rebound in transaction volume, and still-tight spreads suggest to us that the incremental reward for additional risk is not terribly compelling.

KEY TAKEAWAYS

- While equity market conditions grew relatively placid in the second quarter, interest rates bounced sharply off post-bank failure lows as hawkish Fed rhetoric re-established itself as the dominant driver of sentiment.
- The higher cost of capital is weighing on borrowers, and the default rate on broadly syndicated loans is near its long-term average. Rating agencies, meanwhile, continue to downgrade paper at a rapid clip.
- Loan supply and demand were both challenged in the quarter. Pronounced volatility and higher interest rates continued to stymie new-loan issuance, while limited M&A activity has disrupted what is usually a reliable pipeline of borrowers. Collateralized loan obligation (CLO) formation ground to a halt, as high loan prices and expensive financing has made investing in these structures less compelling.
- We have been de-risking the portfolio in various ways over recent quarters and expect to remain defensively positioned until greater clarity emerges.

1. Source: Bloomberg; June 30, 2023.

Higher Cost of Capital Continues to Weigh on Credit Fundamentals

It increasingly has been a tale of two markets in the US, as signals coming from the equity and fixed income markets appear to have fallen further out of sync. Given strong year-to-date returns and volatility at pre-Covid levels, equities appear to be pricing in a soft landing for the economy as the Federal Reserve continues to wage war against inflation. Fixed income markets, however, are flashing warning signs. The yield on two-year Treasuries backed up during the quarter to the 5% level that preceded March's bank failures, further inverting the yield curve, while measures of interest rate volatility remained elevated.²

While fixed income markets had seemed to coalesce around the "higher for longer" narrative toward the end of the first quarter, mid-March's bank failures called into question the Fed's willingness to follow through on this strategy amid such systemic fragility, pulling rates lower across the curve. While this notion dominated market action for the next several weeks, rate sentiment began to shift with the Fed's May 3 policy meeting. Though the 25 basis point increase, which brought the federal funds rate target to 5–5.25%, was dubbed by some as a "dovish hike" given the messaging that accompanied it, rhetoric from Fed governors in the days and weeks that followed made it clear there was still work to be done in the fight against inflation.

This was amplified at the central bank's mid-June meeting; though the fed funds rate was left untouched, many considered this a "hawkish pause" in light of Powell's comments and the introduction of a new dot plot showing rates peaking at 5.6% later this year. Indeed, minutes released a few weeks later revealed that a "strong majority...expect that it will be appropriate to raise interest rates two or more times by the end of the year," per Chair Powell. Additional hikes would not come as a surprise; while headline inflation has improved markedly on the back of falling energy and food costs, core inflation remains sticky, reflecting resilient economic activity and a still-strong labor market.

As a result of these shifting narratives, rates have more or less made a round trip over the past four months, with both two-year and 10-year US Treasuries retracing their pre-bank failure levels. In addition to being pricey, capital is being rationed in certain parts of the system, and bank-lending standards have tightened to levels consistent with recession.³ Higher debt servicing and refinancing costs across the loan complex show few signs of easing in the near term, and are likely to be a headwind to free cash flow, interest coverage and other issuer fundamentals.⁴

Higher debt servicing and refinancing costs show few signs of easing in the near term

Loan defaults by volume—a backward-looking indicator—have climbed nearly 100 basis points year-to-date and at 1.71% are now within striking distance of the 10-year average of 1.86%. By issuer count, defaults are already running above average. The distress ratio—a forward-looking indicator that reflects loans trading for less than 80 cents on the dollar—eased during the quarter, thanks in part to defaulted loans falling out of the measurement cohort; at 6%, however, the ratio remains well above its five-year average near 3.8%.⁵ Certain sectors of the market may be particularly vulnerable to default and distress; health care continues to be challenged by high labor costs, for example, while highly levered technology and software credits are getting hit hard by the higher cost of capital.

Rating agencies, meanwhile, maintained their pessimistic outlook for credit performance going forward, and downgrades outpaced upgrades in June for the 13th consecutive month.⁶ Lower ratings tend to curb the demand for loans, and a bias toward downgrades typically results in greater price volatility, less new issuance and more refinancing challenges.

2. Source: FactSet; data as of June 30, 2023.

3. Source: Federal Reserve; data as of June 30, 2023.

4,5,6. Source: PitchBook | LCD; data as of June 30, 2023.

Demand Was Weak, but Enough to Buoy Loan Prices amid a Dearth of Supply

New-loan issuance continued to be sluggish in the second quarter thanks to pronounced volatility and the high cost of capital; the \$100 billion issued represents the slowest first half since 2010 and is off 40% from the first six months of last year. Par amount outstanding in the Morningstar LSTA US Leveraged Loan Index contracted by \$12 billion, or 0.9%, in the first half of 2023, and secondary market liquidity remained unsurprisingly tight as a result.⁷

A rebound in equity prices and the uncertain trajectory of the economy has weighed on M&A activity, which is a key source of demand for lenders. What new issuance did occur in 2023 was dominated by refinancings and amend-and-extend deals. On the bright side, we believe this has further improved what already was a manageable near-term loan maturity wall; the value of loans maturing in 2024 was cut in half, while 2025 maturities declined by a quarter. Notably, however, the loans that are coming due in those two years are primarily rated B- or below, a cohort that may face challenges securing financing in what is likely to be a tight borrowing market.⁸

Collateralized loan obligations (CLOs) are the primary source of demand for syndicated loans, and the lack of CLO formation in recent months has hurt. With loan prices high and financing expensive, the economics of these structures—particularly in the riskier tranches—is not compelling for investors. Another CLO-related source of near-term consternation for loan demand and liquidity is the unusually large percentage of outstanding CLOs exiting their reinvestment periods between now and year end. CLOs are structured to have finite lives, and there are guidelines in place that dictate what managers can and cannot buy during the various stages of a CLO's lifecycle. The closing of a CLO transaction is followed by a two to five year reinvestment period during which the manager may buy or sell loans with few restrictions beyond compliance with deal covenants. The reinvestment period is followed by the amortization period during which cash flows from the CLO portfolio are returned to debt holders in order of priority, with any remaining proceeds distributed to equity investors. Once a CLO is in amortization, managers are highly constrained in their ability to trade. While fewer than 10% of CLOs typically go out of reinvestment and into amortization during any given quarter, about 40% of the CLO market will do so by the end of 2023.⁹

The lack of CLO formation has been a key factor in the tepid demand for loans.

The pace of activity in the middle market direct lending space was also sluggish. It's worth noting, however, that private lenders have provided financing for more non-leveraged buyout (LBO) deals—which may include refinancings, add-ons and other M&A activity, and dividends—than the syndicated loan market for the past five quarters. And while private lenders have outpaced syndicated markets in LBO financing for some time, more recently they have begun to underwrite the very large loans that historically have been the province of the syndicated market.¹⁰ An uptick in M&A activity could provide interesting opportunities for private lenders and their massive amounts of dry powder.

7,8,10. Source: PitchBook; data as of July 11, 2023.

9. Source: Bloomberg; data as of January 5, 2023.

More of the Same

Uncertainty continues to be the primary driver of activity in the leveraged credit markets. Transaction volume is unlikely to pick up until market participants have greater clarity into a whole host of risks--risks that spread levels do not adequately reward, in our view.

We have been de-risking the portfolio in various ways over recent quarters and continue to do so such that we can maintain the optionality to take advantage of potential opportunities as they emerge. We're biased toward liquidity, which means we're buying more broadly syndicated loans and less direct lending and focusing on higher-quality paper. We have continued to be thoughtful about loan structuring, which we believe provides an added measure of downside mitigation, and have sought to incorporate at least one financial covenant and/or liquidity test in all of our directly originated loans. We expect to remain defensively positioned until we have greater clarity.

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Broadly syndicated loans (BSLs) are loans extended by a group of financial institutions (a loan syndicate) to a single borrower. Syndicates often include both banks and nonbank financial institutions, such as collateralized loan obligation structures, insurance companies, pension funds or mutual funds.

Collateralized loan obligations (CLOs) are financial instruments collateralized by a pool of corporate loans.

A **credit rating**, as represented by credit quality breakdown, is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of credit worthiness of an issuer with respect to debt obligations, including specific securities, money market instruments or other bonds. AAA ratings denote the lowest expectation of default risk. They are assigned only in cases of exceptionally strong capacity for payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.

Federal funds rate is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis.

Leveraged buyout (LBO) refers to an acquisition in which the purchase price is financed with debt to be repaid by cash flow generated by the acquired firm.

Bloomberg US Aggregate Bond Index is an unmanaged broad-based benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM passthroughs), ABS, and CMBS and is not available for purchase.

Bloomberg US Corporate High Yield Bond Index measures the performance of the US dollar-dominated, 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. Bonds from issuers with an emerging markets country of risk are excluded.

Credit Suisse Leveraged Loan Index measures the performance of the investable universe of the USD-denominated leveraged loan market. The index inception is January 1992. The index frequency is daily, weekly and monthly. One cannot invest directly in an index. Indices do not incur management fees or other operating expenses.

Morningstar LSTA US Leveraged Loan Index is a market value-weighted index designed to measure the performance of the US leveraged loan market.

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- Restrictions on transferring interests in a private investment strategy;
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- 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;
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