Creditflux

Q2 2022

Credit Rendezvous

Pass masters

As inflation bites, managers are seeking issuers who are able to pass on rising costs

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Conflict and rising costs add to problems caused by covid

Apart from investment grade, where issuance was strong, credit had a tough time in the first quarter of the year. But for now at least issuers are well capitalised and the default rate is holding steady

Credit has hit its first roadblock since the coronavirus pandemic, and this one is altogether different to that predicament. Whereas the challenge two years ago was all about coping with lockdowns, this time there are a range of factors weighing on managers' minds.

From a humanitarian perspective, Russia's invasion of Ukraine stands alone. The impact on financial markets, however, has been limited. But severe knock-on effects — a shortage of wheat and other grains among them — could be around the corner.

Meanwhile, familiar foes such as covid and inflation are persisting. In fact, rising inflation is viewed as the most obvious catalyst for a new default wave, although it may be late this year or early 2023 before defaults pick up materially as companies fail to pass on rising costs to their customers.

That said, credit took a pummelling in Q1, with high yield suffering most. Primary markets effectively shut down in the latter part of the quarter with one exception: investment grade issuance went through the roof as issuers tried to get ahead of rate rises.

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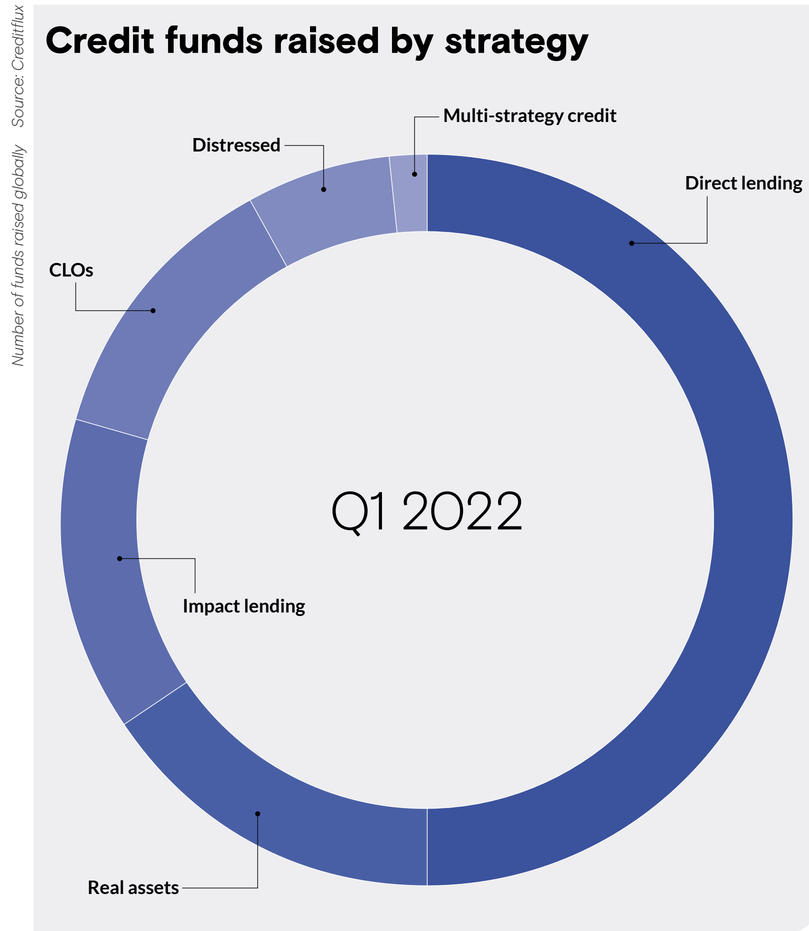

32 direct lending funds were raised in Q1, as well as a healthy amount of CLO funds, as issuers sought to raise captive funds

Largest funds raised in Q1 2022

Fund	Manager	Category	Raised (m)	Currency	Notes
Blackstone Capital Opportunities Fund IV	Blackstone	direct lending	8,750	USD	Final close, exceeded $7.5bn target. The fund will invest primarily in privately negotiated transactions, including growth financings, LBOs, recapitalisations, refinancings and add-on acquisitions originated in the US and Europe
Crescent Direct Lending Fund III	Crescent	direct lending	6,000	USD	Final close. Provides first lien and unitranche investments to private equity-backed US lower middle market companies with $5-35 million ebitda
Oaktree Real Estate Debt Fund III	Oaktree	real assets	3,000	USD	Final close. Around 55% of the fund has been deployed, with investments concentrated in the US, Europe and Australia
PGIM Senior Loan Opportunities I	PGIM	direct lending	2,400	USD	Final close. Closed in January and announced in February. Focuses on investments across non-sponsored and sponsored middle market companies, investing globally
Madison Realty Capital Debt Fund V	Madison Realty Capital	real assets	2,080	USD	Final close, exceeded $1.75bn target. The fund will originate and acquire loans across asset classes, as well as investing in transitional and special situation loans. It will also provide financing for ground-up development and construction

Source: Creditflux

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US CLOs

The sofr transition is slowing new issue, but floating-rate demand points to brighter prospects

CLO liabilities defied an almost ideal technical landscape to move wider in the first quarter. While macroeconomic and geo-political factors were key to CLO tranche underperformance, disputes between debt and equity investors meant that the transition from Libor to Sofr was pricklier than in other asset classes, leading to softness in demand for CLO liability tranches and a 50% slowdown in CLO issu-ance from 2021.

"The market had a harder time digesting the Libor to Sofr transition than we'd anticipated, then layer on top of that the outbreak of hostilities in Europe and macroeconomic vola-tility, and the CLO market was never really firing on all cylinders," says Sycamore Tree's Scott Farrell.

"That's left us in a place where the market is still struggling to find its footing, though it feels like we've turned a corner and have started to see some more deal creation."

Investors are keeping an eye on margin pressures as input costs and rate rises hurt corporate balance sheets. Some sectors see more acute issues than others with commodity prices, though inflation in shipping and haulage is returning toward pre-pandemic levels.

Despite these headwinds, the technical backdrop for CLOs is strong. "As a floating rate product we benefit from rate increases," says Farrell. "There have been significant inflows into the space, whether retail money or CLO creation, because loans and CLOs present one of the few scalable high-quality floating rate investment opportunities that's an attractive alternative to traditional fixed income."

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It feels like we've turned a corner and have started to see more deal creation

Scott Farrell

Portfolio manager, Sycamore Tree Capital Partners

Bullish

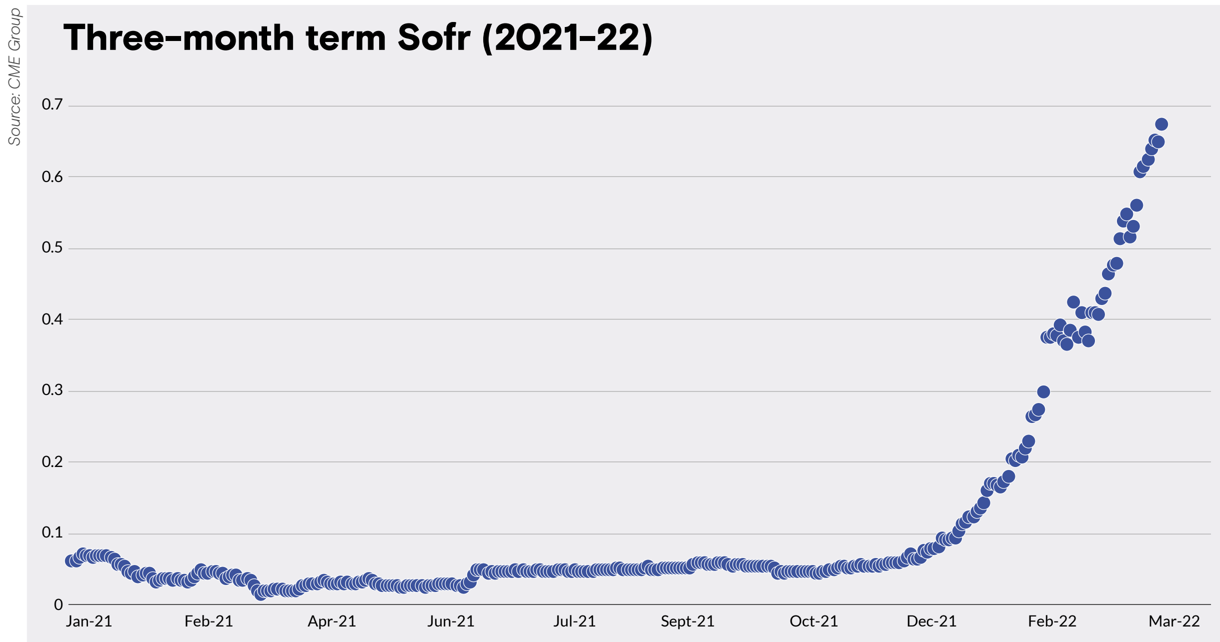
Demand returning among big CLO investors

Bearish

The ability for inflation to be contained

Greatest challenge

Margin compression, and the follow-through effect on earnings



Sofr was tested through a volatile period in credit and came through, reacting to market volatility as the basis to Libor fluctuated

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European CLOs

Loan market needs to deliver as CLO issuers lie in wait

In early 2022, market participants expected a busy year underpinned by more than 50 European CLO warehouses. However, prior to Easter, funding costs widened out to around 230 basis points, with triple As going above 120bp, as investors priced in risks such as inflation, recession, rising interest rates, the Russia-Ukraine war and a resurgence of covid. This slowed CLO issuance.

Vedanta Bagchi says CLO issuance in Q2 will depend on the primary loan pipeline (through the likes of Morrison's, Unilever's tea business, Intertrust, 888/William Hill) and their spreads. Other potential large buyouts that may lead to debt issuance include Telecom Italia, Boots, Ted Baker and Bundesliga.

He says another challenge in Europe is the large number of CLO managers (around 65) chasing loans in a market which is a quarter the size of its US equivalent. There are also another 8-10 new managers in various stages of discussions about launching CLO platforms.

"This could not only lead to a risk of high collateral overlap with respect to the large debt complexes, but could also result in dilution of loan underwriting standards," Bagchi says. "In this respect, a combination of manager track record, CLO structures and CLO documentation may lead to further tiering and consolidation, resulting in a strong set of managers, which will have benefits for the market in the long run."

In Europe, the Euribor floor during a period of negative rates has helped CLO economics. However this is fading as the European Central Bank is expected to follow the Federal Reserve and Bank of England in raising rates.

Still, Bagchi is bullish on the performance of CLOs. In fact, the default rates of CLOs have been far lower than corporate default rates. Additionally, CLOs offer attractive spread pick-ups versus similarly rated corporates. These factors, coupled with the fact that these are floating rate instruments that get protection from duration volatility, make CLOs attractive.

Increasing importance of ESG

European CLO managers are embracing environmental social governance principles, in particular by excluding industries such as thermal coal, tobacco, pornography, payday lending, weapons and opioid manufacturing.

This is expected to continue as more managers adopt positive screening practices.

more ≫

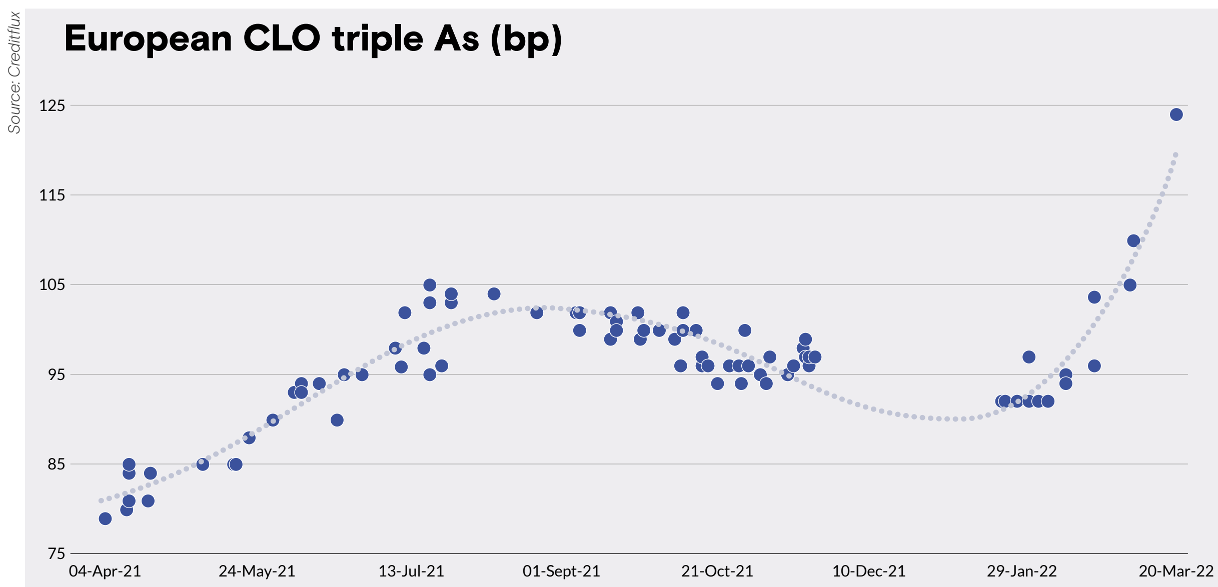
Vedanta Bagchi
Director, Commerzbank Investment Office

Bullish
Triple As and single Bs

Bearish
Availability of suitable assets for CLO managers to invest in primaries

Greatest challenge
Multiple headwinds including inflationary pressures, recessionary risks, rising interest rates, impact of Russia-Ukraine war and resurgence of covid in countries such as China

We may see further manager tiering



Source: Creditflux

Russia's invasion of Ukraine took European CLO triple As from a consistent 92bp towards 125bp in two weeks

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US direct lending

Staying close to home spares mid-market companies from many macroeconomic risks

The US direct lending market weathered the Libor to Sofr transition smoothly, with the floors underlying middle market loans tempering some of the issues that were amplified in the broadly syndicated space. While companies are struggling with commodity price inflation, the asset class is more domestically oriented than other segments of the credit market in the US.

"The middle market is much more contained in the US ecosystem. Around 80% of our borrowers have their employees, assets and facilities all in the US," says Brightwood's Sengal Selassie. "That said, energy prices and the supply chain crisis have clearly impacted some of them."

The last three months of 2021 were the biggest ever for direct lending deal volumes, but broad volatility in the first quarter saw primary activity stall. Selassie says the second quarter should see the beginnings of a rebound. "There's still some pent-up demand from the covid days, which is still one of the big demand drivers," Selassie says. He forecasts that volumes will be up around 10% from the same period in 2021. "We're cautiously optimistic but realise everything could change rapidly given some of the factors at work in the macro economy."

Selassie says the direct lending industry, which has been one of the fastest growing segments of the credit market for years, is set to see an increase in consolidation in the coming months.

"There have been a lot of new entrants to direct lending in recent years. Now the industry is going through the next phase of evolution, and you're seeing a lot of consolidation, and the investor side is looking for differentiation between direct lenders."

more ≫

Sengal Selassie

Chief executive officer, Brightwood Capital Advisors

Bullish

Healthcare and tech telecoms

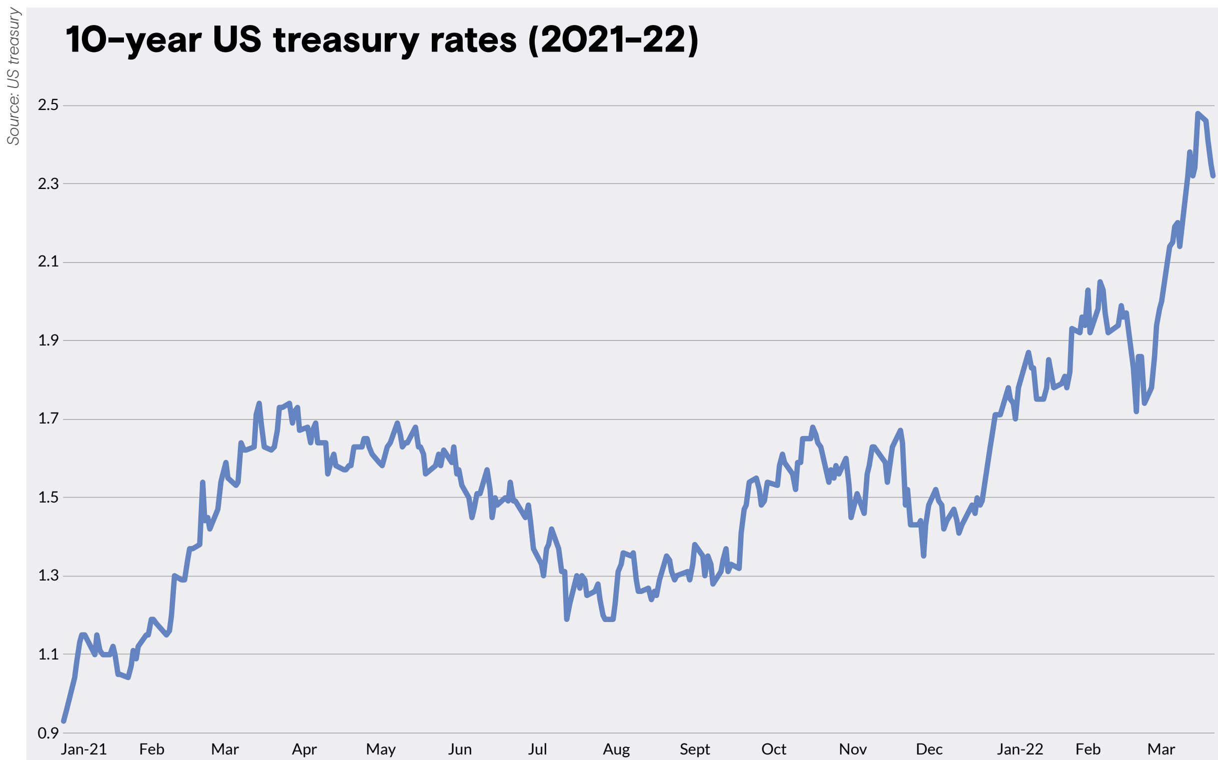
Bearish

Direct to consumer businesses

Greatest challenge

Recession risk

The industry is in a phase of consolidation



10-year treasuries headed back to where they were midway through 2019 as it dawned on investors how rapidly rates could rise

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European direct lending

Largest-ever deal is being prepared as pipeline grows

European direct lending deals are growing in size, with *Creditflux*'s sister publication *Debtwire* reporting that HG and TA Associates are lining up to provide Europe's largest private credit financing to date. The deal — a £3.3 billion ($4.3 billion) covenant-lite debt package to refinance UK-based business software provider The Access Group — is expected to provide a £2.2 billion cov-lite unitranche and a £1 billion acquisition line.

"We are seeing an increasing number of private credit opportunities for large issuers wanting certainty and deliverability of funding in the context of a volatile public credit market," says Mike Dennis of Ares.

He says it will also be important to see how deals that were underwritten prior to this period of volatility fare in terms of their syndication — they may create some attractive secondary opportunities.

Real time assessment of macro-economic headwinds, particularly inflationary pressures on existing portfolio companies, will remain the greatest challenge for direct lenders, says Dennis.

One positive for the sector is that equity market volatility is leading to an increasing number of public to private transactions.

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Mike Dennis

Co-head of European Credit, Ares Management

Bullish

Strong pipeline

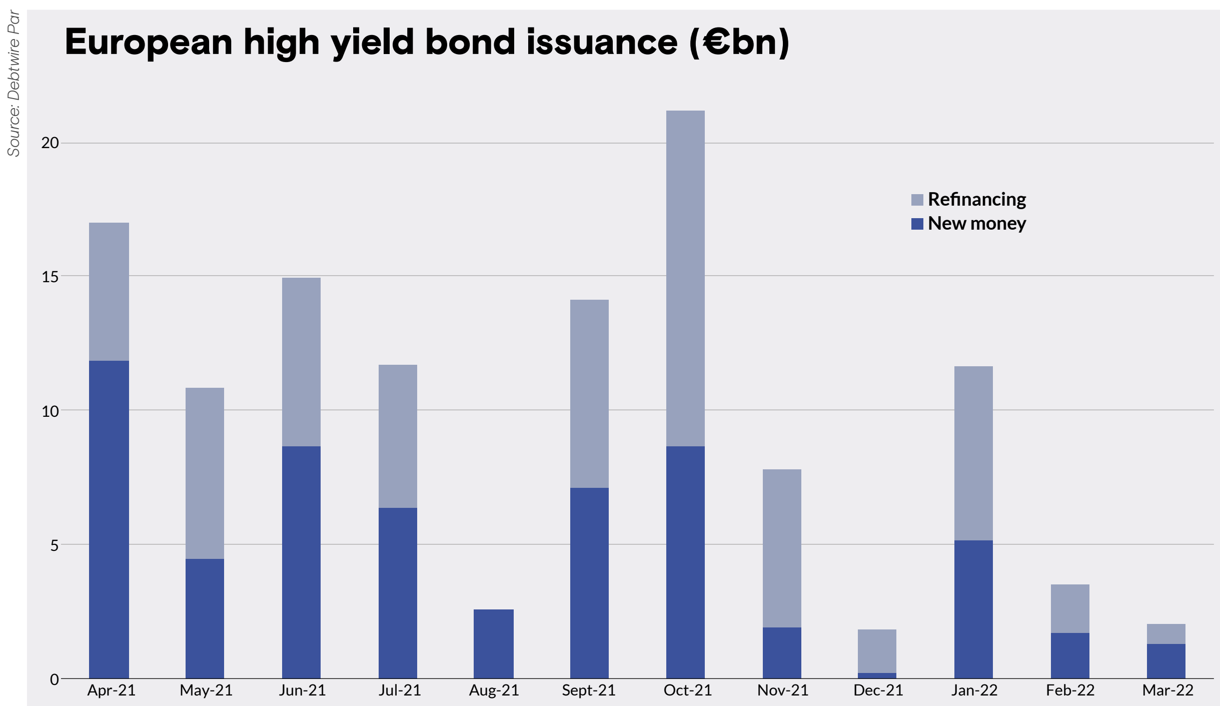
Bearish

Macro-economic headwinds

Greatest challenge

Measuring inflationary pressure for portfolio companies

There are opportunities for large issuers seeking certainty and deliverability of funding



Source: Debtwire Par

High yield new issuance was almost non-existent come quarter end, falling short of even August's holiday-impacted figures

Credit derivatives

Europe and US diverge as focus turns to avoiding cyclicals

Even with much of the market's focus on US Federal Reserve policy, it is Europe that has endured heavier trading and more day-to-day volatility — something most easily seen in the underperformance of iTraxx credit derivative indices and their constituents versus their CDX counterparts.

Downside risks to European growth look set to build in the second quarter, which some believe leaves room for greater dispersion within European credit.

"Even with European inflation hitting 7.5% in March, our European economists believe that quarter-on-quarter growth will fall close to zero in Q2," says Finbar Cooke.

"The impact of global sanctions on Russia are really yet to show up in the numbers. But consumer confidence has already taken a sharp hit and we think there will be follow-on repercussions for consumer behaviour, particularly discretionary spending."

Widening in the first half of the year (pan-European investment-grade credit option-adjusted spreads have moved from 100bp to 135bp so far in 2022) has not been associated with a widening in the 'cyclical premium'. This premium has only moved from 10bp to 20bp, notes Cooke. In comparison, the higher rates environment of late 2018 moved it out to 40bp.

"Clothes retailers could be vulnerable," he says. "As well as pressures on transport costs and labour, the primary input costs are higher, with cotton prices up 40% year-on-year. Pricing power will be limited in this environment."

Auto makers are vulnerable for similar reasons, since rising household energy bills could translate into lower disposable personal income and thus lower intentions to buy new vehicles. Barclays Research downgraded their EU-plus-UK passenger car sales to +2.9% in 2022, from +9.9% previously.

"And finally, in the airline sector, some companies have hedged a smaller portion of their fuel bill than others," adds Cooke.

more ≫

Consumer confidence has already taken a sharp hit

Finbar Cooke

Co-head European credit trading, Barclays

Bearish

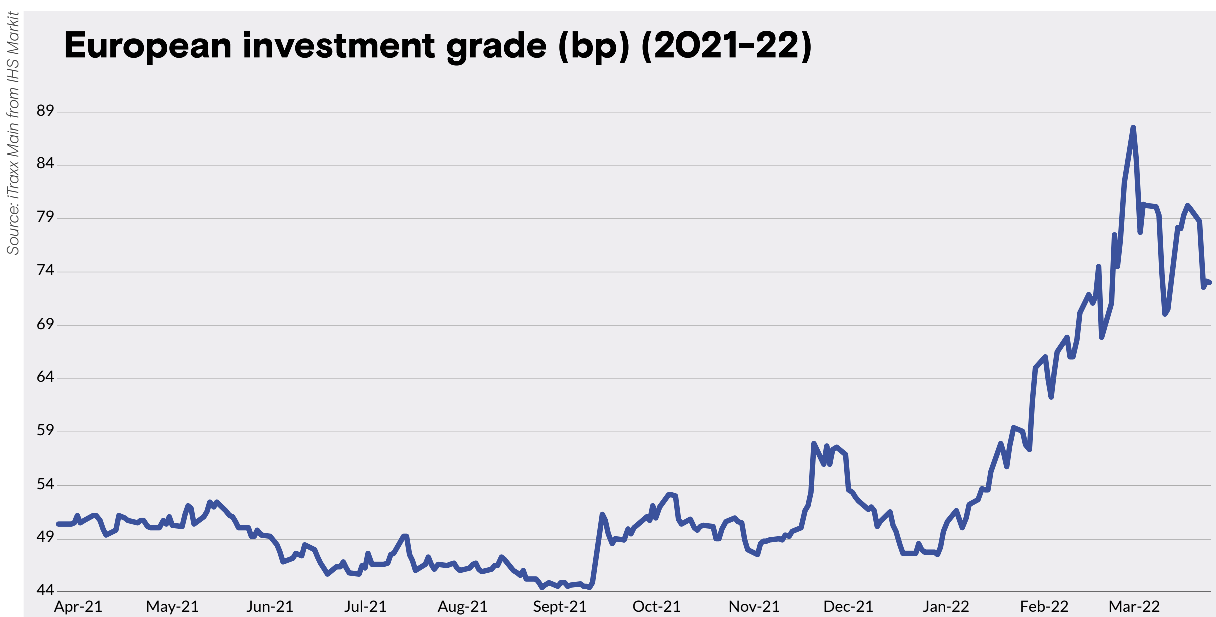
Cyclical credits in sectors such as consumer/retail/autos/airlines

Bullish

Non-cyclical credits in sectors such as telecoms, pharmaceuticals, healthcare and supermarkets (not utilities because they are very vulnerable to cost of living crisis)

Greatest challenge

Timing the slowdown



Source: iTraxx Main from IHS Markit

At one point, European IG went as wide as it was in mid-April 2020. It has since rocked back and forth as the war in Ukraine continues

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Structured credit

Mortgage concerns are growing in RMBS, although house price rises are a positive

Almost all structured credit products had a record 2021, but risk-off sentiment defined the first quarter of this year. Spreads rose significantly across asset classes, leading some securitisations to get pulled as investors waited for clarity.

"We got wonderful execution on our inaugural securitisation late last year and were pleased with the depth of buyers, but if we'd done it three months later, the execution would have been wildly different," says Atalaya co-founder Ivan Zinn.

"It wouldn't be uneconomic, but we may have waited since buyers from triple A on back wanted short duration assets and were waiting to see the interest rate picture before starting to put more risk on. Deals were either pulled or meaningfully widened."

Zinn expects pricing will continue to widen, but issuance is likely to increase into the second quarter as ABS issuers gauge price discovery.

"People will need to get their deals in before rates go up again," Zinn says. "After not doing deals in the first quarter as they waited for some retrenchment or certainty, people will feel urgency to do something."

As in other asset classes, fundamentals remain in good shape, but investors worry about interest coverage. House price appreciation is a positive for the RMBS market, but rate rises mean mortgage affordability is becoming a pressing concern for consumers.

"People are expecting a greater return today, so existing securities are worth less because the new securities are going to price differently," says Zinn.

"It's good reminder of how credit investing will be harder going forward than it was in the past decade."

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People will need to get their deals in before rates go up again

Ivan Zinn

Chief investment officer, Atalaya Capital Management

Bullish

Consumer credit

Bearish

Corporate high yield, auto and student lending

Biggest Greatest challenge

Exiting the decade-long goldilocks period

US HY wound back to November 2020 levels and is now firmly settled north of 360bp

Distressed debt

Creative financing will shine as companies pass on inflationary costs

As credit started 2022 on solid footing, credit investors might have expected relatively few distressed opportunities to arise. But the picture has changed markedly with high inflation (the transitory theory now seems like wishful thinking), central bank intervention through interest rate hikes and the war in eastern Europe.

Distressed debt investors have told *Creditflux* that, of all these factors, inflation is the most likely catalyst for a distressed phase. Angelo Gordon's Nicola Mueller agrees inflation will be a key theme but points out that it could take a while to play out, as companies have done "astonishingly well" to pass on costs to consumers.

"Consumers are effectively absorbing all the price increases," she says. "It will take time, but consumers will realise how the price of key household items has risen and they will have to adapt their spending."

Mueller says there has been a belief consumers saved money during the pandemic in 2020, but she argues this is most applicable to US consumers. Europeans, on the other hand, could face the prospect of eating into their savings much sooner.

It will take time, but consumers will realise how prices have risen

Nicola Mueller

Vice president, Angelo Gordon

Bullish

Those companies that did not refinance and extend debt maturities last year, as well as some cov-lite loans

Bearish

Limited opportunities in the secondary market

Greatest challenge

A prolonged distressed cycle is some time away so fund managers need to present creative financing solutions to borrowers

London-based Mueller foresees good opportunities in two areas. First of all, there are several companies that were unable to take advantage of a red-hot primary market to lower debt coupons and extend maturities. Given how sharply inflation has risen, these issuers will face pro-forma cashflow problems. Some of these corporations will be able to tap into revolving credit facilities, but that will only provide a few months of cushion. Another opportunity set could be covenant-lite loans.

Mueller says that fund managers need to be creative to get the most out of these openings. "We could, for instance, talk to cov-lite loan issuers about moving assets and creating financing backed by these assets. The company could then use the proceeds to retire their existing debt at a discount."

Patience will be important, however. Mueller says that in Germany, for example, there have been "liquidity bridges" popping up, with companies still being able to contact the government for support, ostensibly as part of covid-relief programmes.

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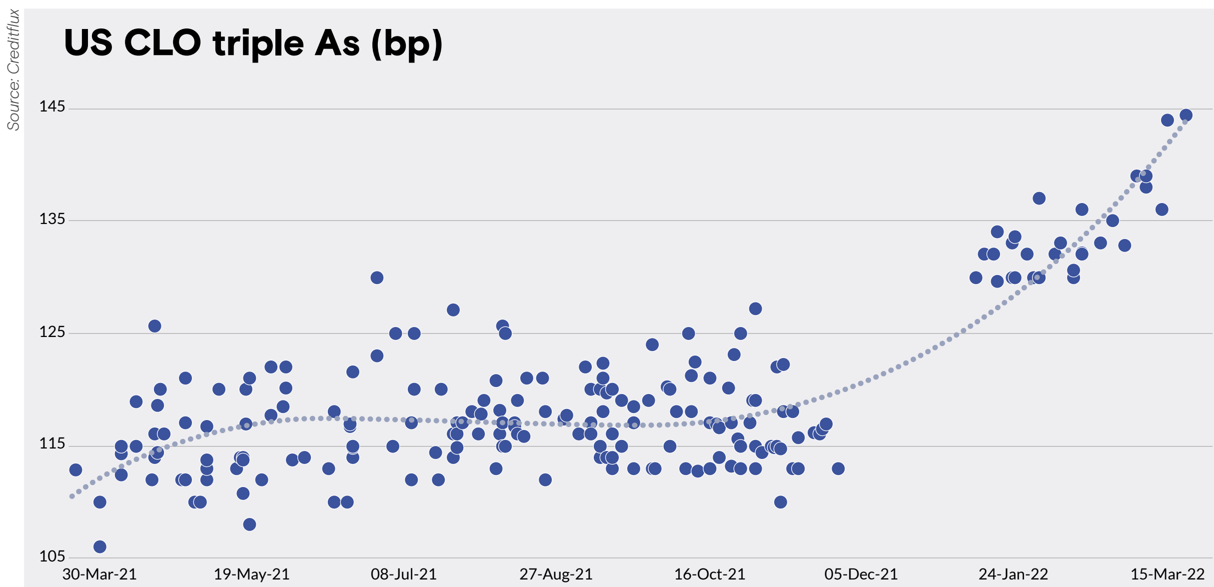

Having got the hang of Sofr, CLO issuance was rolling. Issuers are now regularly doing three-year deals for the first time since late 2020

US loans

Focus switches from rates boost to idiosyncratic risks caused by war and supply bottlenecks

Loans have retraced lost ground following the outbreak of war in Europe, and the fundamental outlook remains benign. But loan managers are making different investment assessments than they were at the start of the year, when interest rate rises suggested boom time for the floating-rate asset class.

"When loans were trading at tights in January, and we were thinking about how rates would move over the course of the year, we were looking at supply chain and inflationary constraints as transitory and expected to see signs of improvement on the post-covid rebound," says Philip Raciti. "Our expectation then was spread compression for the following quarter or two on the back of strong earnings growth and increased demand from retail funds due to the rising rate environment."

Raciti says the recovery in loan prices was hampered by the Russia-Ukraine war and China's zero-covid policy, which created supply bottlenecks in semiconductors and autos. "As a result, we're now having a lot more discussion around the potential for error in execution and idiosyncratic risk across borrowers."

Interest coverage for issuers remains benign, with Raciti saying that the forward default rate should remain close to the historical average of 2%. Higher quality loans with triple and double B ratings have recovered fastest, while lower rating bands are lagging, with upgrades from triple C keeping B3-rated loan prices higher.

"There's still liquidity for B3s but it's much less than higher credit quality," says Raciti. "When you get a drawdown like we saw in March, it's not really surprising."

The S&P/LSTA US Leveraged Loan Index started the year at 98.64, dropping as low as 95.88 on 15 March, before recovering to 97.6 by the end of the month.

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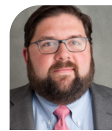


Philip Raciti

Head of performing credit, Bardin Hill Investment Partners

Bullish

Capital access

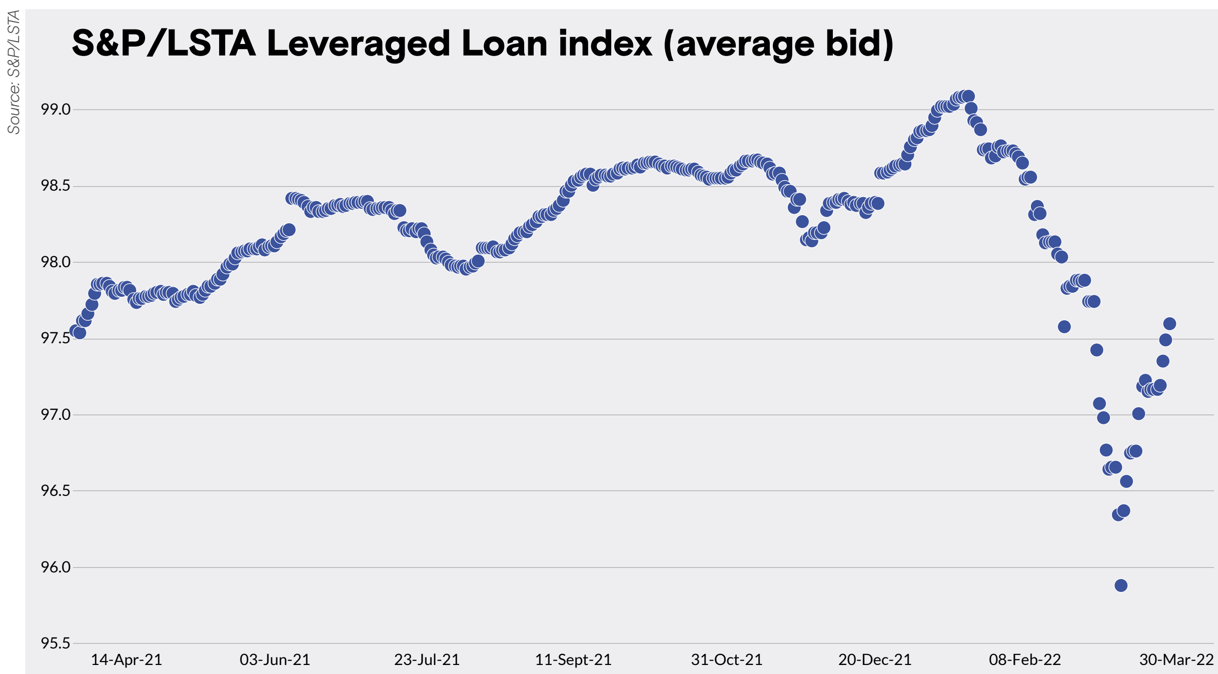
Bearish

Smaller B3/B- borrowers managing interest coverage

Greatest challenge

Long-term impact of deglobalisation

We're having a lot more discussion around the potential for idiosyncratic risk



There was a small window for loan buyers to capitalise on as the average bid fell below 96. Although the recovery was sharp, CLO managers can still pick up some bargains at sub-98 cents

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European loans

Loans go through transition phase and disconnect from CLO spreads

Leveraged loan volumes should hold up for the quarter given the number of deals in the pipeline. The problem in this transition period, however, is that around half of deals have been underwritten under the 'old terms' (before the Russian invasion of Ukraine), which have limited flex language. Sources argue that with CLO triple As hovering around 115 basis points over Euribor, loan pricing needs to be nearer 450bp/98 cents rather than the 425bp/99.5 for a flat single B loan.

Tyler Wallace says the biggest challenge for loan managers is supply chain inflation in portfolio companies. He also thinks they need to watch fundamentals to avoid credit losses and bulk downgrades (depending on how seasoned the portfolio is).

"Every credit we were in last year was a price maker and could raise their prices," he says. "That's not realistic when looking forward to the second half of 2022 and 2023. Lots of these companies will become price takers, and whatever raw materials they buy — such as wheat — they aren't going to be able to pass that cost increase on automatically."

There will be opportunities for CLOs with relatively conservative portfolios

Tyler Wallace

Portfolio manager, Fair Oaks Capital

Bullish

Return of relative value within European loan markets vs European high yield bond markets

Bearish

Global inflation and supply chain disruptions putting corporate profit margins and cash flow under further pressure. Global geopolitical headwinds

Greatest challenges

Navigating the repricing of credit risk and avoiding credit losses based on deteriorating corporate fundamentals

Managers will need to filter out companies that could come under the greatest pressure. "Profit margins are going to get squeezed, free cash flow conversion will go down and we will see less deleveraging (and probably some re-leveraging), which will at a minimum lead to rating agency downgrades," says Wallace.

He also believes that, with the IPO market quietening, private equity sponsors may not be able to exit an investment via this route. All of these factors could lead to a hardening of the credit cycle, because companies are being squeezed on many fronts.

Wallace estimates that default rates will remain low for Q2 but will pick up by Q4 2022 and 2023. "It will be interesting to see Q1 2022 reporting," he says. "The short of it is, every European CLO will be impacted. But if you have a relatively large exposure to B3s, the downgrade risk from the rating agencies means triple C baskets could get stretched, and some managers may need to sell. This will create opportunities for CLOs with relatively conservative portfolios."

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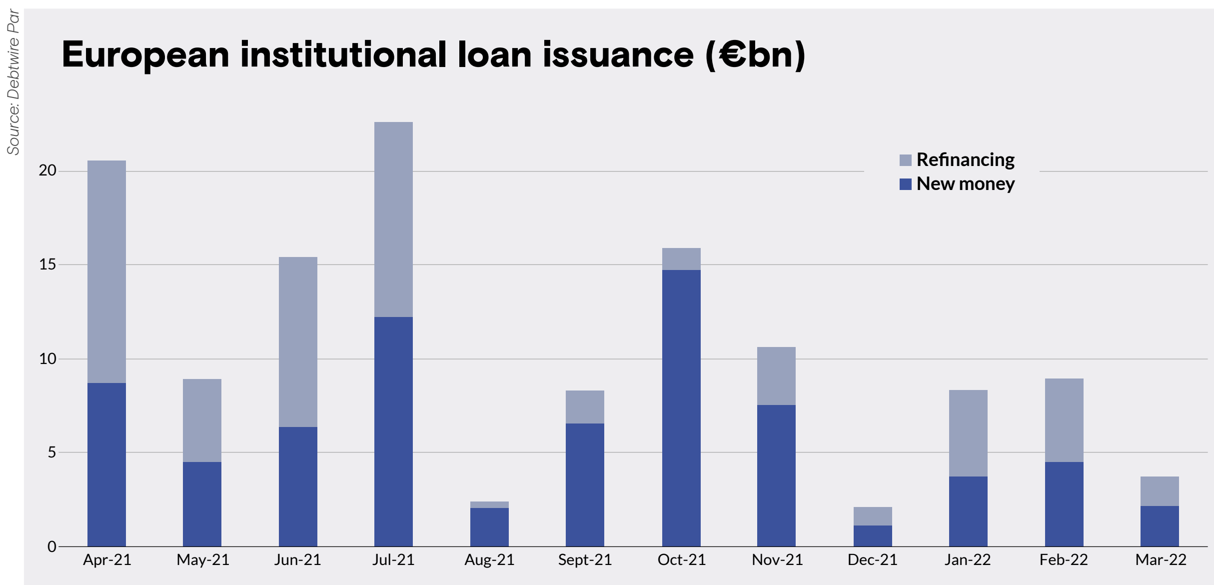
European institutional loan issuance (€bn)



Source: Debtwire Par

It's hardly surprising European CLO issuance has slowed to a trickle with a paucity of loan issuance. The average loan margin in Q1 was 418bp

Emerging markets

Interest rate increases pummel EM credit as focus turns to secondary market

Emerging market credit has faced many of the headwinds other credit asset classes face (with increasing rates a particularly important factor), but in addition it has had to cope with geopolitical uncertainty. As a consequence, prices have adjusted, resulting in negative returns not only from rates but also from spreads.

On the positive side, there have been very few new issues in the first quarter. This prevents even greater repricing in the market.

High yields have been one cause of low issuance, but another is that there has been a dearth of issuance from Chinese corporates, which have typically been responsible for a massive chunk of primary volumes.

This has meant that fund managers have had to scour the secondary market for opportunities. This approach suits Wouter Van Overfelt who prioritises active management. He claims to have consistently turned over 200% of his fund portfolio each year.

Van Overfelt says he also likes to build diversified portfolios when dispersion rises, as it is doing today. He runs an event-driven sleeve to his fund and this has been able to benefit from idiosyncratic risks.

“We look for bonds where the market has over-reacted,” he says. “In these cases, the focus is on whether the issuer can improve its credit quality. We focus on credit risk rather than interest rate risks.”

Interest rate increases have been the foremost driver of performance this year. “Benchmark returns are down 9% this year and roughly half of that is attributable to an increase in risk free rates. By comparison, the war in Ukraine has had a much smaller impact,” says Van Overfelt, who is based in Zurich.

Looking ahead, Van Overfelt says new issuance should pick up in coming months, but he foresees higher inflation than many are predicting, forcing central banks to raise interest rates with more conviction. This will fuel more dispersion in credit.

Emerging market corporate debt yields ranged between 6 and 6.5% in the first quarter.

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We focus on credit risk rather than interest rate risks

Wouter Van Overfelt

Head of EM corporates, Vontobel

Bullish

Chinese corporates and the shorter duration available across EM corporates

Bearish

Bonds with higher sensitivity to interest rates (EM corporates and in particular EM HY corporates have very low interest rate sensitivity), middle eastern credits and passive management

Greatest challenge

Pricing in the multitude of risks

6 to 6.5%

Range of first-quarter emerging-market corporate debt yields

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Macro credit

Europe and US set to diverge as focus turns to ECB

This year's first quarter set the scene for 2022 as emphasis shifted from US rate fears to the wide-reaching turmoil of a major European conflict. Credit spread spikes have so far been less dramatic than during the first wave of global covid-19 cases in 2020, but the cocktail of macroeconomic troubles suggests a much more persistent run of high volatility could persist through the coming months — and perhaps the whole year.

"The main macro themes for the coming quarter are again going to be centred around the impact of the Ukrainian conflict on an already dire inflation/growth mix outlook," says Eric de Sangues. "The looming quantitative tapering in the US and end of QE in Europe will broadly reduce liquidity in fixed income products at a time where the growth outlook looks challenging at best, especially for European economies."

This is a major cause of concern for European credit investors, as the continent's technical picture is imbalanced. The ECB has bought all the net supply in EU corporate bonds since the start of the year, but its asset purchase programme is expected to end in June. The burning question is what may happen if the ECB opts to stop reinvestments and start quantitative tapering as well as trying to tame inflation.

Germany especially is in the spotlight as a potential total cut-off from Russian gas poses another tail risk for the EU economy.

"In this context, and even if it's a consensus trade, I like short EU/long US credit in various forms, like indices, options and tranches," says de Sangues.

"I like decompression trades, ie Crossover versus Main in indices or with payer option combinations, and I like dispersion trades in Crossover tranches, for example, long senior tranches, short junior tranches. I like long SX5E equity volatility funded with short CDX IG/HY credit vol."

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Eric de Sangues

Head of macro credit, Fairwater Capital

Bullish

Decompression trades (especially iTraxx Crossover versus Main) and dispersion trades (especially through Crossover tranches)

Bearish

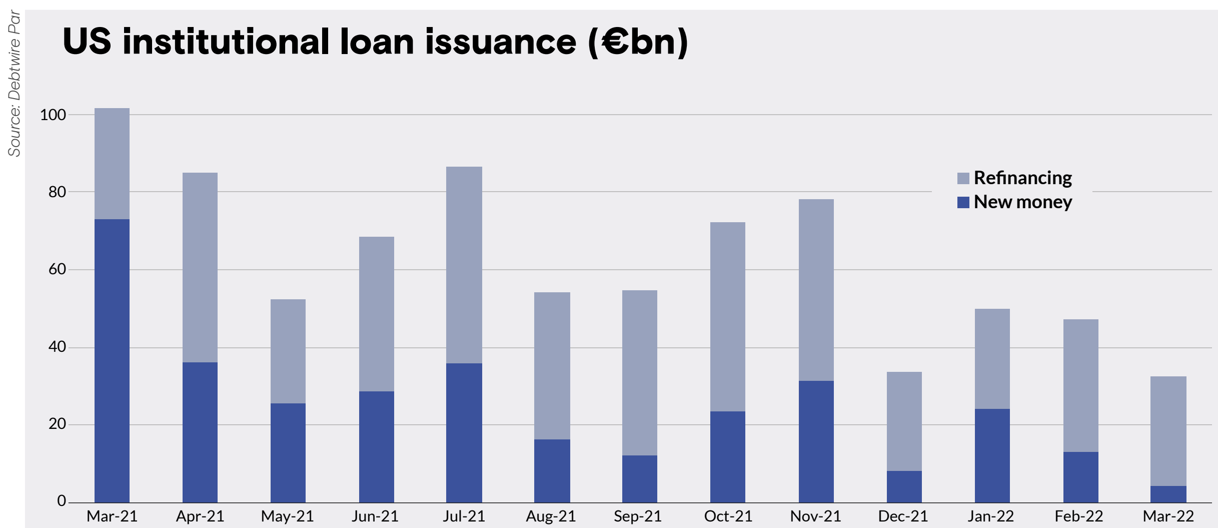
EU versus US credit (through indices, options and tranches): it's a consensus view but makes a lot of sense and has only just started

Greatest challenge

Navigating the timing of ECB/Fed tapering and its impact on liquidity in credit

Quantitative tapering in the US and end of QE in Europe will reduce liquidity in fixed income

Source: Debtwire Par



New issuance dropped to $28.3bn in March as the average margin in Q1 drove up to 395bp

Investment grade

Issuers get ahead of rate rises amid huge primary volumes

Investment grade credit defied the malaise across primary credit markets to end the first quarter with a flurry. In one of the most productive-ever months, roughly $131 billion of US IG bonds printed in March, while €43.5 billion priced in Europe.

Issuance in Q1 was skewed towards the back-end as companies sought to lock in financing and extend debt maturities ahead of interest rate hikes.

Vanguard's Kunal Mehta, who is based in London, says issuance for the remainder of 2022 will likely be lower, but one of the overriding positives so far this year is how IG credit has absorbed the correction to higher rates. "The ECB's change of stance was quite unexpected, and although the US Fed's hawkish rhetoric was not unexpected, the aggressive nature of its interest rate increases was," he says.

As central banks withdraw liquidity, Mehta expects yield curves to react. "In Europe we don't know which portion of the yield curve is held by the central bank," he says. "There is going to be a normalisation of the curve and that will be exaggerated by investor behaviour and fund flows."

Kunal Mehta

Head of fixed income product specialism, Vanguard

Bullish

IG has adjusted to rate hikes faster than any other market; liability-driven investors moving into IG; selective triple Bs

Bearish

The three Ds — dislocation, devaluation (both from rate hikes), and demanding (more credit analysis required especially closer to a potential recession)

Greatest challenge

Being patient and taking long-term views rather than eking out every basis point of return

Mehta expects curves to flatten, especially given how crowded short duration credit is becoming. Much like investors in other markets, he is looking for companies that don't face demand elasticity and can therefore pass on inflationary costs to consumers. "These will be the outperformers and that will show in the resiliency of their curves. When liquidity washes away, you will want to be overweight these names," says Mehta.

When liquidity washes away, you will want to be overweight these names

Companies in industrials, energy and utilities could be the standouts. Another area to look for is M&A, and specifically those companies — such as Dell — that have committed to deleveraging by selling off non-core parts of their business.

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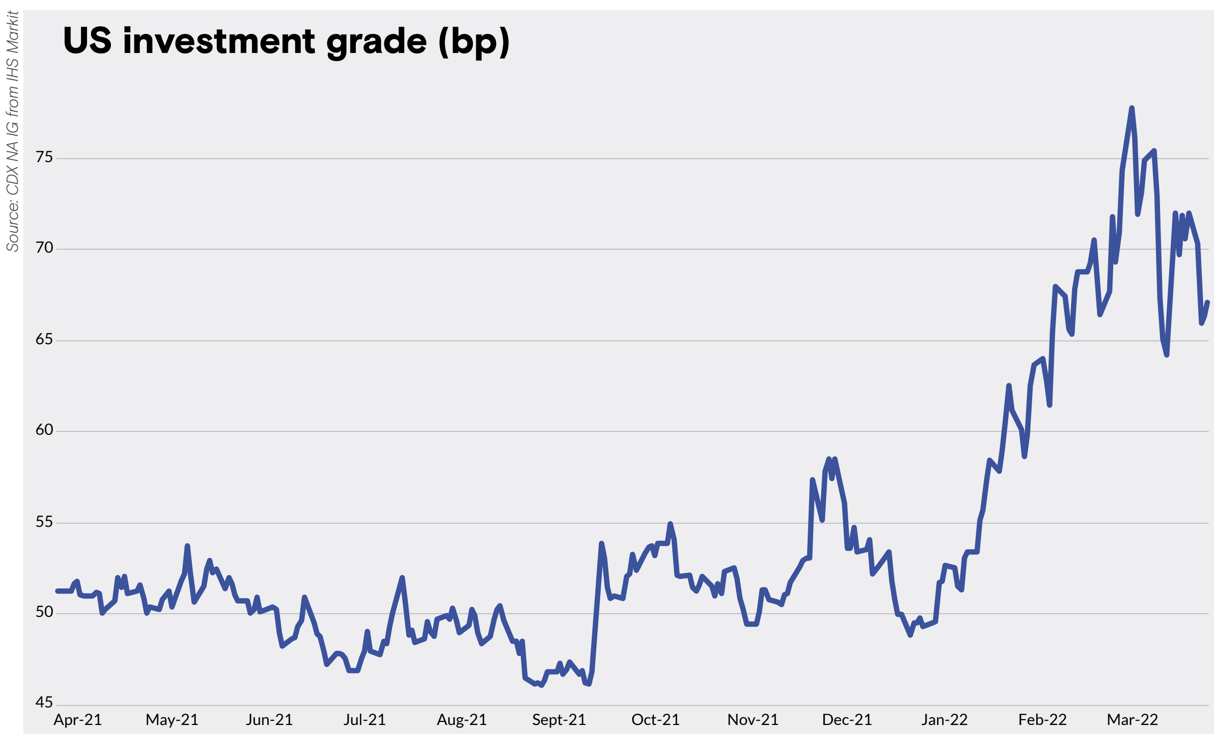

US IG did not react quite as much as European IG to Russia waging war in Ukraine. Spreads drifted back to May 2020 levels, but the US has routinely been 10bp tighter than Europe

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Real assets

Some infrastructure debt markets have tightened in Q1 to be one of the few bright spots in credit

Infrastructure debt volumes dropped to $53.9 billion in Q1 after a record-breaking Q4 when $212.8 billion was issued.

Publicly traded bond credit spreads have pushed wider, most notably in high yield markets. But private infrastructure debt markets have generally been resilient given underlying revenues are often naturally linked to inflation across this sector. (In some markets credit spreads have actually continued to drift tighter.)

"This pricing gap applies in particular to the sectors where there is a lot of activity supporting the energy transition and technological innovation, such as renewables and digital," says Amie Stow.

She says Russia's invasion of Ukraine and inflation have combined to cause a decline in sentiment in the real estate debt space. She cites a Property Management Analysis survey which found that although attitudes towards real estate debt have become less positive in Q1, they are still positive overall, and above long-term averages.

This pricing gap applies in particular to the sectors supporting the energy transition

Stow says that across credit investors are looking to diversify and that is drawing more attention to real asset debt. Issuers are looking to tap into this.

"After years of relatively lower issuer diversification (principally driven by higher education and housing associations), UK corporate private markets have seen — pleasingly — a return of more traditional corporates to the market, looking to take advantage of strong investor demand by refinancing before potential further coupon increases."

more ≫

Amie Stow

Head of Private Credit Solutions,
LGIM Real Assets

Bullish

Shorter and medium durations and investments that help promote the energy transition and meet decarbonisation agendas

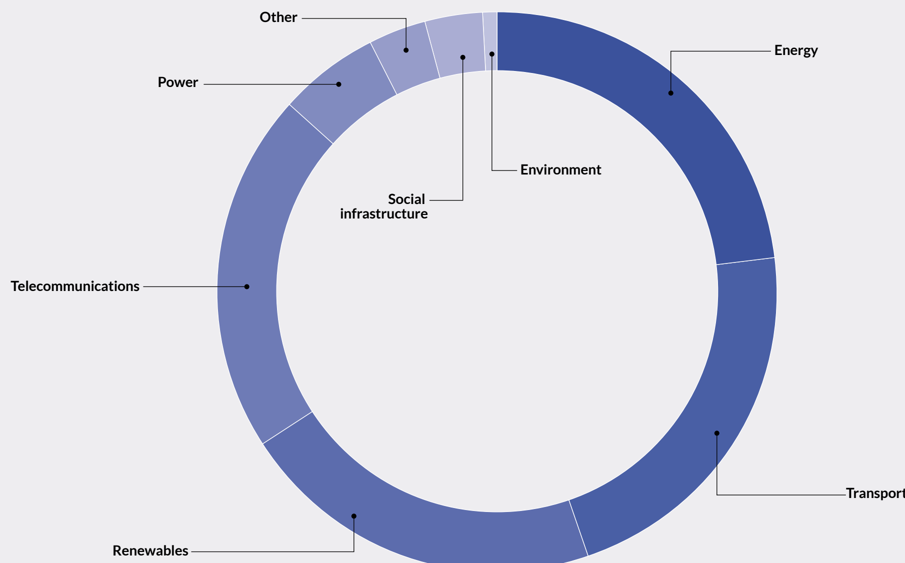
Bearish

Persistent and long-lasting inflation and hawkish central bank response. Also, investments with a strong link to consumer discretionary spending and/or energy price inflation

Greatest challenge

Maintaining discipline amid competition for assets

Infrastructure loans by sector (Q1 2022)



Source: Infralogic

Renewables are a big focus for infra loan buyers, but it was the third most productive area, behind transport and energy

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Global high yield

HY hit by negative returns, but higher quality universe of credits bodes well

Global high yield experienced another month of negative returns in March, ending a difficult quarter for the asset class. US high yield was at an average dollar price of 103 at the beginning of the year. Bonds have now fallen to 95.

US high yield issuance slumped to $40-50 billion year-to-date versus $150 billion-plus last year for the same period. Counterintuitively, yields rose, and spreads tightened, due to a variety of factors. The pull-back on supply helped the market from a technical perspective, while upgrades into IG totalling around $40 billion also played a role in the supply/demand balance. The positive performance of the energy sector and a default rate that remains below 1% also played into this.

Research suggests only 4.5% of the bond and loan market matures between now and 2023, which lowers the risk of a spike in defaults. "Spreads probably shouldn't go back to historical levels because on average the market is more highly rated than in the past five years," says one source. "Capital flowing out of China and eastern Europe also appears to be moving into the US, which again may have helped spread stability."

Market participants say they expect lower issuance this year, with some M&A coming through the loan market, or even from private debt.

Bob Kricheff says one of the most interesting sub-strategies in global HY — as the European Central Bank gets hawkish and the Fed talks about being aggressive on inflation — is short duration US high yield with a focus on high credit quality.

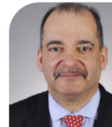
"That sector of the market is probably down about 3 points in price since the beginning of the year and has held up fairly well," he says. "Broad HY is down around 6% year-to-date, but the short duration part of that is only down around 154bp." He adds that short-duration HY should help investors if the markets turn and inflation unwinds quickly.

On the flip side, high volatility and inflation have made emerging markets HY relatively unattractive. The Ukraine-Russia war, repeated lockdowns in Asia, and trade pressures and policy choices driven by China, have stressed markets. At the same time, global rising rates (ex-Japan) are not always good for companies in emerging markets.

"We've seen the markets react to higher commodity prices, but it's really the next couple of quarters where you're going to see impacts from disruptions of the food and fertiliser supply," says Kricheff.

He believes the biggest challenge for investors will be getting industry concentrations right.

"If you think about the last couple of years, credit quality and duration mattered more than industry. Now, with supply chain issues and inflation (and consequent consumer demand changes), choosing industries that are less dependent on supply chain and perhaps more service oriented, but with the ability to control labour costs, will make more of a difference."



Bob Kricheff

Global Strategist and Portfolio Manager, Shenkman

Bullish

Low defaults. Short duration, good-quality US high yield

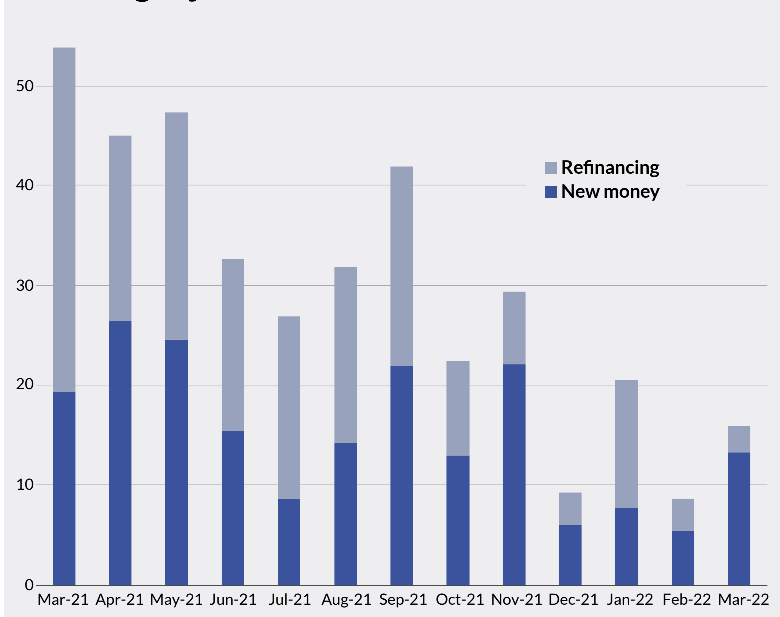
Bearish

Emerging markets HY; high volatility in eastern Europe (Ukraine war); Asia (repeated lockdowns and trade pressures and policy choices by China); rising rates.

Greatest challenges

Getting industry concentrations right

You'll see impacts from disruptions to food and fertiliser supply in the next couple of quarters



Source: Debtwire Par

It has been a quiet quarter, with roughly $45 billion of issuance. By contrast, there was $53.8 billion in March 2021 alone

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