Creditflux

Q3 2022

# Credit Rendezvous

## All change

As strong markets weaken and curves invert, credit investors are trying to find new routes to success


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# Investors prepare to make the most of inflation and recession

*To some, the recession-inflation tag team is a throwback to the 1970s. But many in the credit industry say the dislocations they cause are creating a new world of opportunity*

At the midway point of 2022, almost every area of the capital markets is confronted with a vision of the future that looks very different to what it was at the beginning of the year — and, in many cases, what it was even a month ago.

As inflation marauds across economies, the tendrils of recession begin to curl around asset classes. This old tag-team is creating strange situations where one reality warps into another: floating rate outperformance gives way to underperformance; synthetic credit outperforms cash; rates curves invert; the strong market for commodities becomes structurally weak; and the on-fire world of real estate looks set to crash and burn.

Credit investors are finding ways to navigate these shifting variables — and for some the dislocation could prove lucrative. But others will come unstuck.

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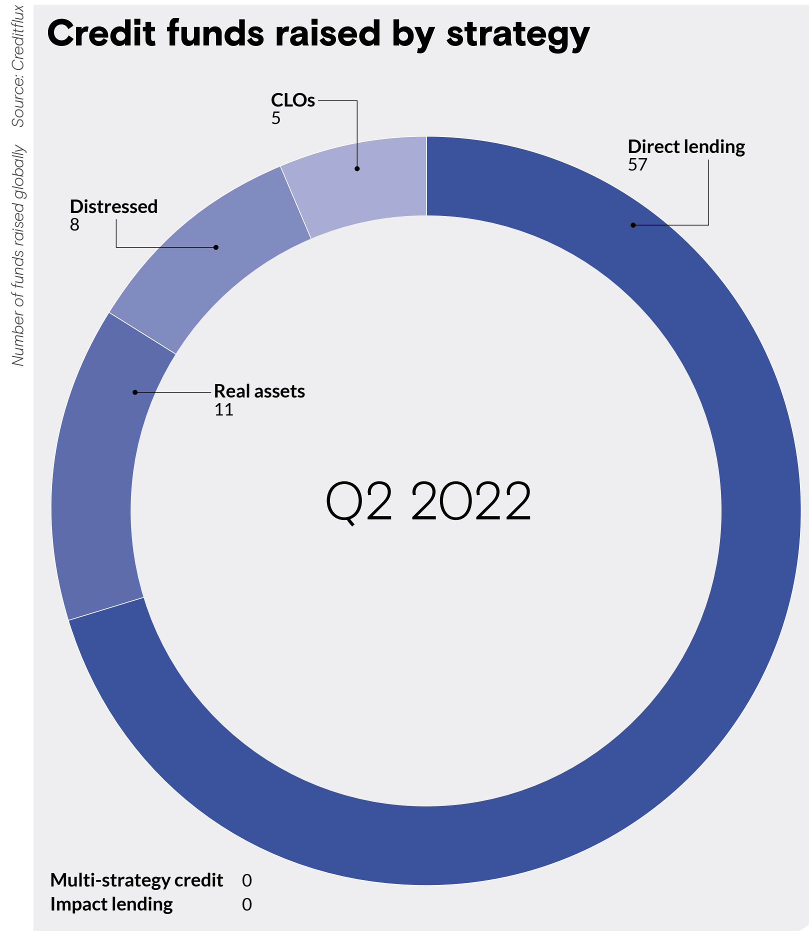


*Direct lending accounted for a whopping 70% of fund raises as investors sought shelter in locked-up forms of credit*

**Largest funds raised in Q2 2022**

| Fund | Manager | Category | Raised (m) | Currency | Notes |
|---|---|---|---|---|---|
| Monroe Capital Private Credit Fund IV | Monroe | direct lending | 4,800 | USD | Final close. Will buy private equity sponsored and non-sponsored lower mid-market debt from North American companies with less than $35m ebitda. It will primarily buy in senior secured and unitranche loan formats |
| Carlyle Credit Opportunities Fund II | Carlyle | opportunistic credit | 4,600 | USD | Final close. Exceeded $3.5bn target. With leverage the fund has about $6bn to deploy with around 67% deployed to 22 companies in North America and Europe |
| Kayne Senior Credit Fund IV | Kayne Anderson | direct lending | 4,500 | USD | Final close. Has collected $4.5bn of investable capital across Fund IV & IV-B, two private BDCs, managed accounts and other vehicles investing alongside the fund |
| Harrison Street Real Estate Partners IX | Harrison Street | real assets | 4,000 | USD | Regulatory filing. Has overtaken the previous fund in the series which closed at $2bn in 2020. Previous funds seek value through buying, developing, redeveloping and/or repositioning assets |
| Thoma Bravo Credit Fund II | Thoma Bravo | direct lending | 3,300 | USD | Final close including leverage. This is the software investment firm's largest credit fund closure to date |

Source: Creditflux

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# US CLOs

*Short non-call periods enable a call or reset when loan prices normalise*

Market participants describe CLO formation as "anaemic", but the second quarter brought $38.4 billion of CLO new issues in the US — a figure only a small distance behind the $40.1 billion in Q2 2021. The seeming inactivity is due to evaporated refinancing and reset volumes. 2021's $58.8 billion of refinancings gave way to a single deal worth $276 million in May this year.

Falling loan prices have left some long-term CLO warehouses underwater, but "print and sprint" transactions have filled the void in the primary market, which in turn has protected leveraged loans from selling off harder.

Optionality is key to the CLO opportunity for an equity investor, according to Miguel Ramos.

"CLO liabilities have underperformed assets, so while it is possible to buy a good loan portfolio in the 90s today, the transaction has to enjoy as much optionality as possible to be compelling," he says. "A short non-call period will support a potential call or reset to monetise any normalisation in loan prices."

## The transaction has to enjoy as much optionality as possible to be compelling

Triple As have borne the brunt of the sell-off on the liability side, widening around 60 basis points between the start of the second quarter to today's levels above 200bp. Without an even greater tightening of loan spreads, the CLO engine is unlikely to resume at full capacity.

"The falling yen is unlikely to increase Japanese demand for US assets and US banks' balance sheets are not expanding anymore," Ramos adds. "The relative value is there — the value you get versus other structured credit assets is significant."

*more ≫*

**Miguel Ramos Fuentenebro**

Partner, Fair Oaks Capital

**Bullish**

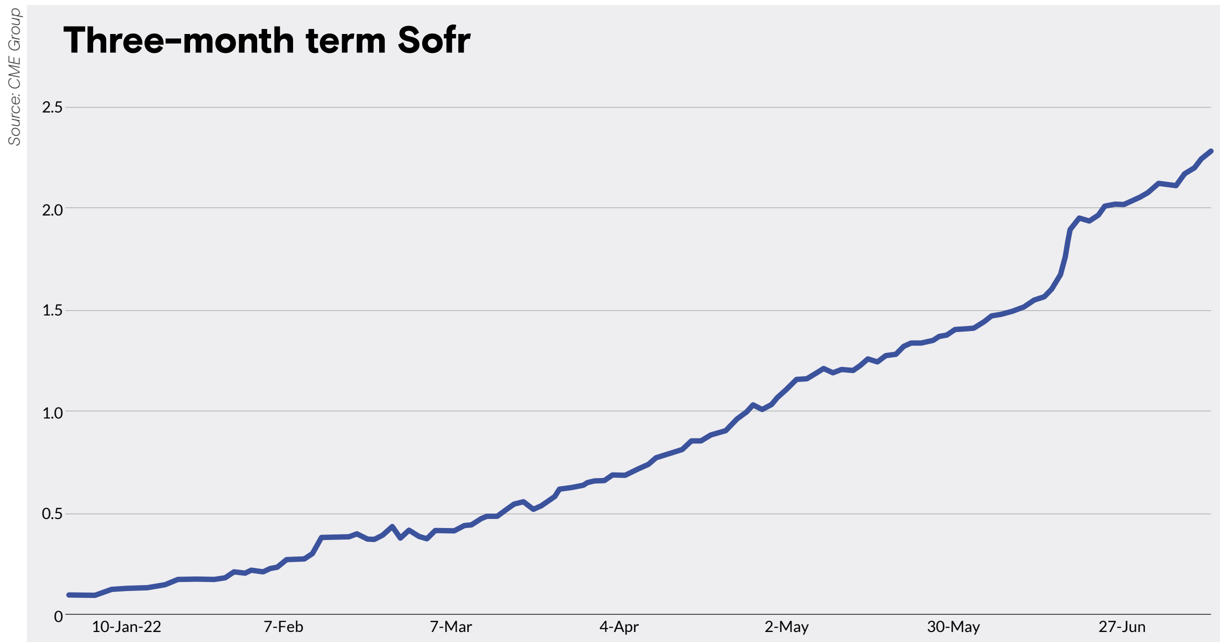
*Secondary equity within reinvestment, single B or double B secondary mezz in both US and Europe*

**Bearish**

*New issue equity with a long non-call*

**Greatest challenge**

*Creating an appropriate arbitrage*




Source: CME Group

*It says a lot about credit in 2022 that Sofr, the headline issue in January, barely registers as an item of interest. 3-month Sofr ended Q2 at 211bp. That was 17bp inside three-month Libor, for anyone still tracking the basis.*

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# European CLOs

*CLO issuance comes to standstill but market is getting creative to create liquidity*

European CLO investors are cautious amid high interest rates, supply-chain bottlenecks and record inflation levels. That led to the longest primary market silence since December 2018, with only one European CLO pricing in June and triple As widening to 140 basis points over Euribor.

CLO strategists cut their new issue forecasts, with Bank of America's down from €37 billion to €22.6 billion, and from €19 billion to €10 billion for refi/resets, while Deutsche Bank's fell from €36 billion to €25 billion. High CLO funding costs also led to a shutdown of reset/refi activity.

In the secondary market, European CLO triple As are trading at over 200bp, while double As and single As are well over 300bp and 400bp respectively. "These are probably the widest spreads we have observed where the market is still operating with some liquidity since around the late-2015/early-2016 oil crisis," says Denis Struc. "Back then, triple A spreads spiked to around 170bp, and double As to 250bp. On that metric alone, assuming one does not believe these tranches will default, valuations look strong and it's a good time to buy CLOs. The only counter argument to this is will spreads get wider — and for how long?"

**Denis Struc**

Portfolio manager, Janus Henderson

**Bullish**

*Creativity of the CLO market*

**Bearish**

*Potential rating agency volatility*

**Greatest challenges**

*Positioning to manage downside risks; raw material costs and ability to pass on cost to consumers; Ukraine-Russia; potential energy crisis*

**CLO spreads haven't widened as much as corporate credit**

## CLOs have held up well so far

The ratio between CLO triple A spreads and corporate credit is still below the long-term average of recent years. "CLO spreads haven't widened as much as corporate credit in relative terms," says Struc. "On one hand this means CLOs held up relatively well, demonstrating less volatility, but at the same time, there may be more room to go should market uncertainty persist."

Triple As for CLOs in the immediate pipeline could widen to the 200bp mark, say sources.

One factor to watch for is ratings volatility, says Struc. After covid, rating agencies were quick to react, unlike during the 2008 global financial crisis. This means the dynamic of downgrades will likely be more fluid than historically.

The CLO investor base has broadened over the past couple of years, across banks and asset managers. If ratings start to deteriorate, investors whose capital charges are linked to this may face pressure to sell, adding secondary supply that will affect spread levels and market prices. But without a big spike in triple C downgrades and defaults, Struc believes the market should not suffer substantial migration in investment grade.

The structural resilience of the CLO market is another positive.

"There are levers to be pulled to create liquidity," says Struc. "We saw this during covid when new issue deals came as early as April and May 2020 post sell-off. Focus on issuing smaller deals, with more club-like syndication where you find committed buyers; sweeten the equity returns with fee sharing; shorten structures; discount OID on CLO bond prices."

But he admits it is not easy to create liquidity — and there is no guarantee that what worked in the past will work again.

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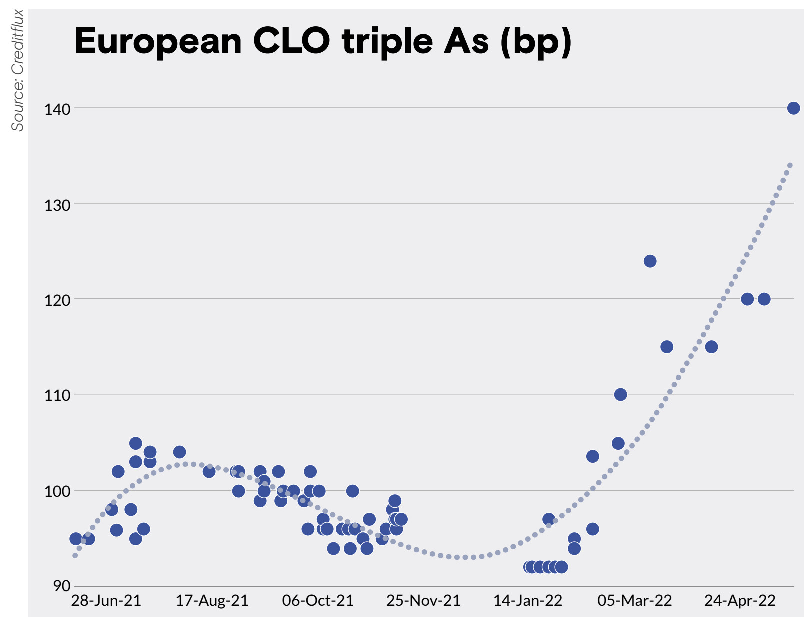


*CLO triple A spreads entered the year in the low 90s. But as credit widened, CLO seniors leaped wider, ending Q2 on 140bp. This is a retreat to August 2020 levels, and the market is still moving wider.*

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# US direct lending

*Rising input costs are piling pressure on small companies — but large-scale defaults are unlikely*

Rising interest rates are a net benefit for direct lending, with the appeal of floating-rate products drawing inflows to private credit in the first half of 2022. Default rates remain at just over 1% but, amid talk of recession, lenders are increasingly concerned about the ability of small companies to pass on costs.

According to Mark Slusar, inflation is a problem for small borrowers, with input costs at some of his portfolio companies having risen by as much as 70% in a year. But supply-chain crises following the pandemic have largely resolved themselves.

"The lower end of the middle market was hit harder by some of the supply-chain issues than larger corporate America, as the largest customers were building excess inventory to prepare for continued disruptions, while smaller businesses were put at the end of the line by vendors," he says. "Most of these businesses have weathered that and a lot of opportunities have opened up. Since they have onshore supply chains, some of our borrowers have the opportunity to sell to other US-based chains because of their geographic locality."

Along with rate hikes, energy price increases and labour shortages are putting pressure on direct lending portfolio companies. As such, July earnings reports are likely to paint a less rosy outlook than other recent quarters. But those stresses are unlikely to translate to defaults on the level of 2020, let alone 2009, says Jason Colodne.

"We actually expect the number of bankruptcies and subsequent debt refinancing to remain relatively low, primarily due to three factors in the market," he says. "These are: the lack of covenants that many of these middle market companies have; private equity's significant influence, given the competition in their pipeline; and the amount of capital raised in the private credit space."

*more* ≫

### Jason Colodne

Managing partner, Colbeck Capital Management

**Bullish**

*Increased opportunities to finance companies going through periods of transition*

**Bearish**

*Heavy industrial and lower market businesses, given generally higher cap-ex requirements and limited ability to pass through cost increases*

**Greatest challenge**

*Traditional direct lenders could have trouble with underlying borrowers trying to ride inflation and interest rate volatility*

### Mark Slusar

Managing partner, Enhanced Capital

**Bullish**

*Renewable energy*

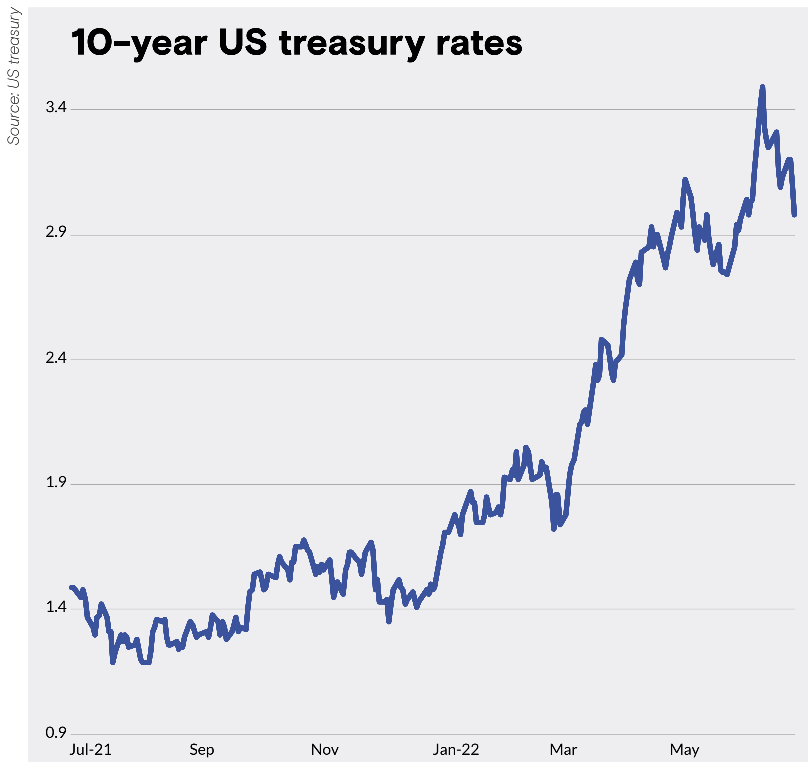
**Bearish**

*Brick and mortar retail*

**Greatest challenge**

*Inflation and supply-chain issues*

## Onshore opportunities have opened up




*10-year US treasury yields hit their highest level in 11 years in mid June, peaking at 3.49%, as investors sought to get ahead of rate rises. The term curve is inverting with three years proving to be an inflection point.*

# European direct lending

*Direct lending flourishes as a capital solutions provider amid BSL shutdown*

In stark contrast to the old, negative view of direct lending as an overgrown shadow-banking industry, proponents of the asset class say it has proven its worth as a stabiliser in a turbulent credit market.

"It has been a perfect storm for direct lenders," says Floris Hovingh. "Having built up enormous amounts of dry powder, they are now the only game in town and are deploying capital at a premium rate to large corporates previously out of reach — either by underwriting directly or working with investment banks as part of an underwriting club.

"Clearly, hung positions have created an opportunity for direct lenders to solve some of the deals that were underwritten pre-Ukraine and haven't been able to launch."

With so much choice for direct lenders, many are scrutinising credit opportunities by predicting the effects of weak consumer demand, high inflation and energy market turbulence on the wider economy and particular sectors. Margin has increased for the best credits, from around 550/575bp pre-Ukraine, to around 625/650bp, sources say. But this is a slight adjustment, which is not comparable to the huge widening seen in capital markets.

Covenant terms continue to converge between high yield bonds, term loan Bs and direct lending, with covenant-lite deals becoming commonplace for deals with greater than €40 million ebitda.

There has also been convergence between banks and funds on existing term loan B transactions, Hovingh says. Direct lenders are being asked to participate alongside syndicated deals on a pari-passu basis for additional loan add-ons.

### Deals grow in size

Direct lenders have been able to underwrite €1 billion tickets for some time, but the market is now willing to pay the premium. However, large numbers of sponsors have chosen not be reliant on a single lender, and instead work with a club.

**Floris Hovingh**

Managing director, Perella Weinberg Partners

**Bullish**

*Rise of direct lending as a capital solutions provider*

**Bearish**

*Convergence of looser covenant terms with bonds and loans*

**Greatest challenges**

*Consumer demand, high inflation, and energy market turbulence on future transactions*

## Direct lenders are now the only game in town

Fundraising is flourishing amid continued strong performance of the asset class as floating rates protect investors from interest rate hikes.

Hovingh says that many European direct lenders have shied away from consumer-facing sectors (which will be hard hit in a recession) and instead underwrote deals in high growth B2B sectors, including financial services, healthcare, and software, which are favoured by private equity.

"A rising interest-rate environment could benefit direct lenders, as they are seeking absolute returns for their end investors, making it easier for them to hit their return thresholds," he says. "But there is a fine balance as portfolio companies could struggle to pay increased interest costs on their debt and default as a result."

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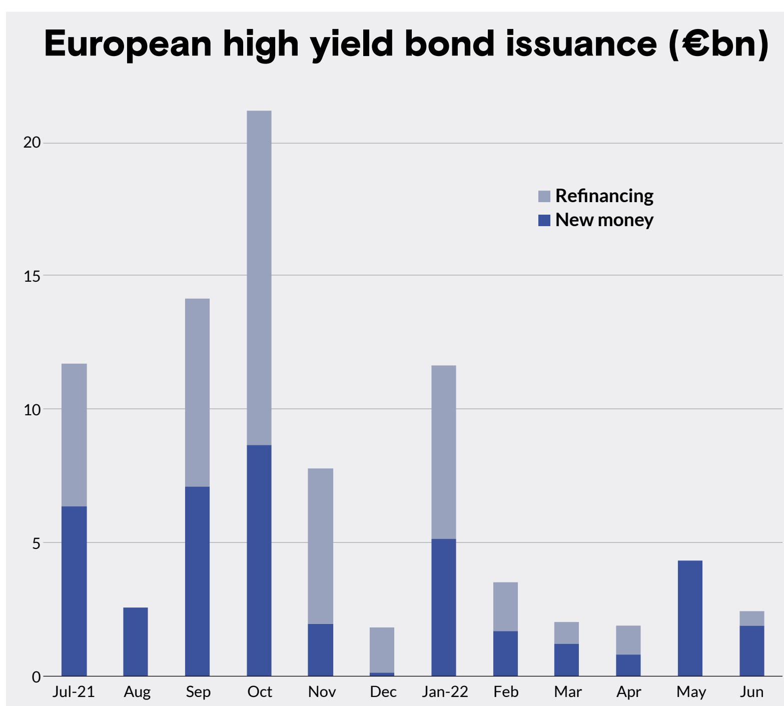


Source: Debtwire Par

*There's not been a desperate need for issuers to extend maturities this year, so HY volumes have been low. The telecoms industry commands 21% of HY market share this year, with four deals for a weighted average yield to maturity of 5.62%.*

# Credit derivatives

*Synthetic portfolios offer flexibility to take advantage of elevated spreads amid primary drought*

Global credit markets have entered the second half of the year at greatly elevated spreads, with a growing sense among investors that risks are at least adequately priced. But taking advantage is difficult at a time when primary issuance markets — particularly in leveraged finance — are constrained. This is where CDS has a chance to shine.

For CLO investors, July brings a coupon payment day that some will struggle to redeploy into the asset class given low volume. And concerns have mounted over the performance prospects of leveraged loans in coming months.

For Ymer, a bespoke portfolio of CDS looks an attractive alternative. “High yield CDS curves are quite flat,” says Hubert Warzynski. “We are evaluating to deploy into the equity tranche of a two-year bespoke with 100 names. These would be tilted towards US high yield companies with strong balance sheets and not exposed to inflation or supply-chain issues.”

The approach comes with recognition further credit deterioration could occur. But the iTraxx Crossover index at 620bp and CDX HY at

**Hubert Warzynski**

Portfolio manager, Ymer

**Bullish**

*Investment grade and better high yield credit (especially US), short maturities*

**Bearish**

*Challenged/distressed credit, especially in retail, energy, food, travel*

**Greatest challenge**

*If Russia cuts gas to Europe it could be a black swan moment*

## We’re evaluating the equity tranche of a two-year bespoke

560bp means the market is pricing in losses of 30% in the next five years. This makes a good entry point for a shorter dated, more credit selective trade, Warzynski believes.

“The pull to par effect is so strong it will offset a decent amount of widening during the next 6-12 months in credit indices,” he says. “We are not bullish, but it is an interesting enough opportunity. US corporates are in better shape or generally less risky than Europe. We have also conducted a lot of studies on index tranches and historically they have never lost money at these levels. Plus, having a shorter duration reduces refi risk, as you can see corporate balance sheets better.”

Risks overhanging the credit market — inflation, recession, geopolitical and supply-chain issues — are still important. But they are better reflected by investor positioning than they were going into the second quarter.

“Russia is a big unknown, but if you take that out of the equation a lot of high inflation is priced in,” says Warzynski. “Everyone who is bearish on credit is probably already positioned. There is no hard evidence of recession yet, and unless we see much worse news one would expect markets to start to normalise. Avoiding sectors exposed to disruption leaves a compelling opportunity.”

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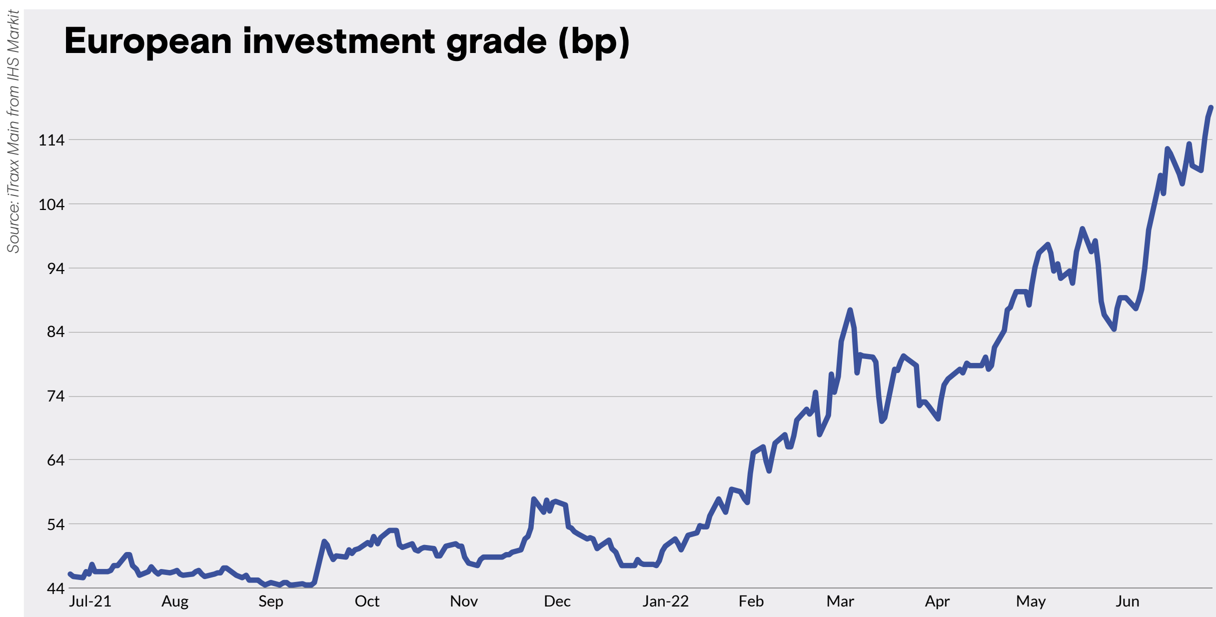



*European credit is now trading wide of its North American equivalent for the first time in years, with European IG ending Q2 about 20% wide of US IG.*

# Structured credit

*Lessons from history point to higher quality and shorter duration as spread widening extends*

ABS has suffered amid the 2022 sell-off, but proponents say their market, which is down just 2% on the year, has fared better than high yield and corporate credit in general.

Consumer-facing assets, such as subprime auto and consumer loans, are causing investors the greatest concern. The uncertainty and volatility in ABS mean investors are seeking safety in higher rated bands and shorter-duration bonds.

Conning's Norris says he has been looking at the 2016 sell-off for lessons and concludes spreads could widen further. "Back then spreads widened pretty meaningfully," he says. "We haven't got back to those levels even in the sectors that have been most impacted."

Since structured credit has less duration risk but offers more carry, issuers believe their products remain attractive. Indeed, sources report interest in ABS increased as prices dropped in the first half of the year.

Conning has continued to raise money to invest in ABS products, with Norris saying they offer several hundred basis points of spread over similarly rated corporate notes and have longer durations, which investors find compelling at the price point.

"Retail investors are pulling money out, which has pushed spreads wider," Norris says. "Our clients are insurance companies and others who are showing even more interest in the sector at this point."

And he adds that, as investors become more defensive, spreads in higher quality parts of the capital structure are coming in, especially for short duration assets.

more ≫

**Paul Norris**

Managing director and head of structured products, Conning

**Bullish**

*Non-qualified mortgage lender triple As*

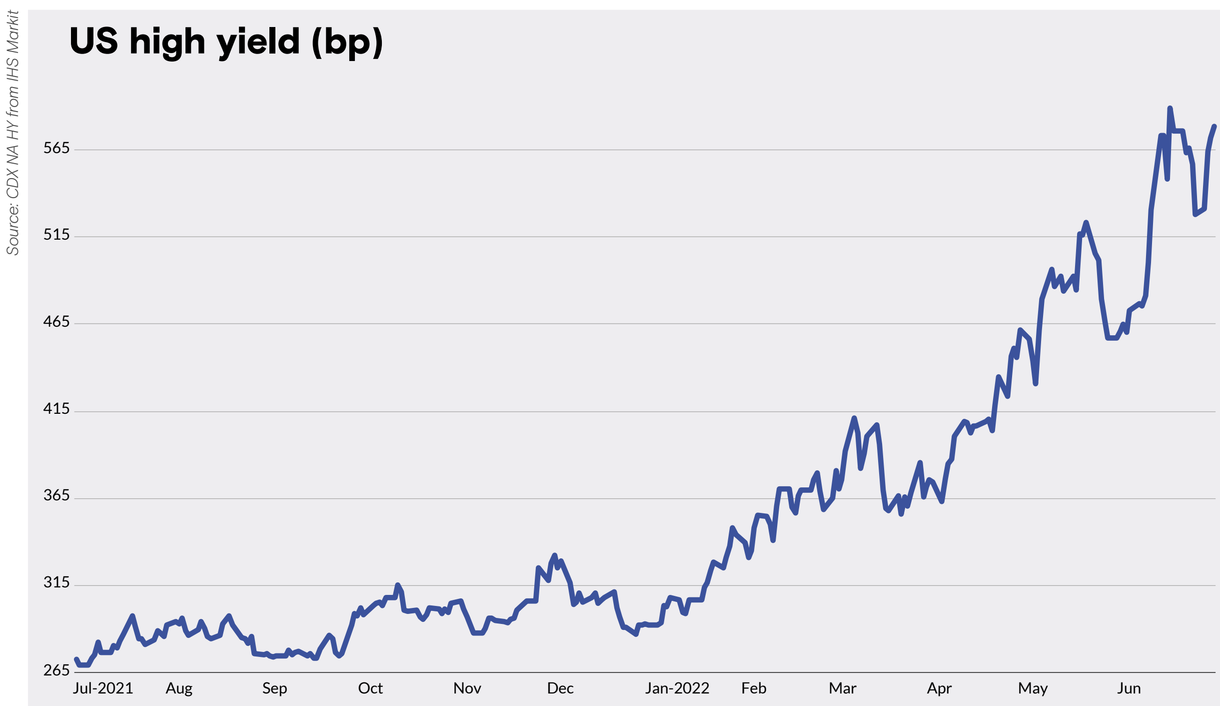
**Bearish**

*Marketplace lending*

**Greatest challenge**

*How consumers weather inflation once their savings have dried up*

**Our clients are insurance companies and others who are showing even more interest at this point**




*Compression has been evident between IG/HY CDS indices this year, but HY has been more volatile of late, fluctuating between 590bp and 528bp before widening to 579bp in the space of two weeks in late June.*

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# Distressed debt

*CLO pull-back creates opening for distressed funds in primary loan market*

Distressed debt investors are used to scouting for opportunities, but today the best value may be hiding in plain sight — in the new issue US loan market.

"This is the first time since 2008/2009 that we are seeing new issue loans pricing in the 80s," says Matthias Ederer. "During the covid outbreak, we did not see this stress feed into the primary markets because banks were not long the same amount of risk."

The opening for distressed funds has come about as US CLO formation has slowed. Although new US CLO volume was healthy at $37.79 billion in Q2, five-year reinvestment CLOs accounted for just $22.61 billion (this profile of CLO is best suited to buying new issue loans).

New York-based Ederer says there has been a disconnect between buyers and sellers in the secondary loan market, with the two sides several points apart. That has closed in early July and Ederer says "lock step changes in secondary are feeding through to primary".

He gives the example of MHS, which was being marketed in late May with an original issue discount applying to the loan at 98 cents. It took five weeks for this to drop in stages before clearing at 89.5 cents. At this kind of discount, these sorts of loans can achieve the double-digit returns distressed funds crave.

The greater role played by distressed funds in the primary loan market is having an impact on documentation. "In hung deals we can apply a higher level of scrutiny," says Ederer. "Normally, when we submit our comments on loan terms the syndicating bank says 'Thank you, but we have three times your order where the investor has no comment'. The pendulum has now swung to being much more lender friendly."

Another contrast between the market today, and the months after the covid outbreak in March 2020, is that outflows from exchange traded funds and mutual funds have been orderly and fairly consistent over the past few weeks. For loan investors it is a slow grind down, rather than an immediate hit, says Ederer.

*more ≫*

**The pendulum has now swung. Loan deals are much more lender friendly**

**Matthias Ederer**

Partner,
BC Partners

**Bullish**

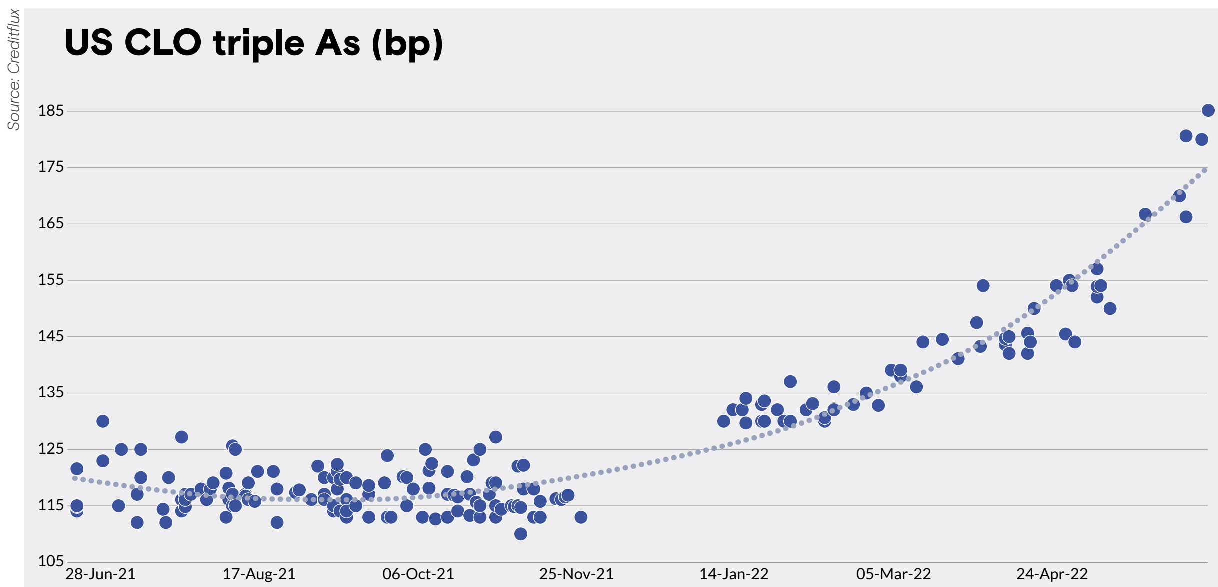
*The primary loan market is, for once, providing better opportunities than secondary because the CLO bid has fallen away*

**Bearish**

*The secondary market is in denial about how bad the situation is, causing loans to leak wider in stages as investors ascertain their true value*

**Greatest challenge**

*Deciding how to spend resources on the most actionable opportunities. Focusing on the right names is critical*




Source: Creditflux

*Worries over the Sofr transition seem a distant memory. But a difference to 2020's covid crash is that today, five-year US CLOs are printing. Unusually, these are pricing at roughly 180bp — about 40bp tight of three-year deals.*

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# US loans

*Search for safe-havens will put floating rate back on the front foot*

Even with floating rate protection in a rising rate environment, leveraged loans were not immune from the sell-off that afflicted all asset classes in the second quarter. The S&P/LSTA Leveraged Loan Index reached a low of 91.75 cents on 6 July, having traded around 98 cents at the start of April.

Much of the selling in the loan market has been driven by mutual and exchange traded funds, which suffered outflows of $1.17 billion in late June. $620 million was driven by mutual funds, while ETF outflows hit $550 million. The trend is a reverse from earlier in the year, when investors rushed into floating-rate loans in anticipation of Fed rate hikes.

### Reversing the reversal

John Kline expects the trend to reverse again. "Leveraged loans are supported by secured debt structures and pay a floating rate, making them especially attractive to investors as central banks tighten monetary policy," he says. "If the equity and broader fixed income markets continue to underperform through the summer, we believe investors looking for a safe haven will begin returning to leveraged loans."

M&A activity has slowed from the record-breaking year in 2021, but the downturn in loans has been less than in other asset classes. Much activity in the sector has pivoted from syndicated to private markets.

"As a result of rising rates and attractive spreads, private leveraged loans have remained one of the best performers in the fixed income market," says Kline. "Some of this year's largest buyouts have been financed by attractively priced leveraged loans provided by direct lenders. These have helped fuel the space's continued growth and relative outperformance."

*more* ≫

**John Kline**

Managing director,
New Mountain Finance
Corporation

**Bullish**

*Enterprise software, subscription database companies, life sciences, healthcare services, healthcare tech*

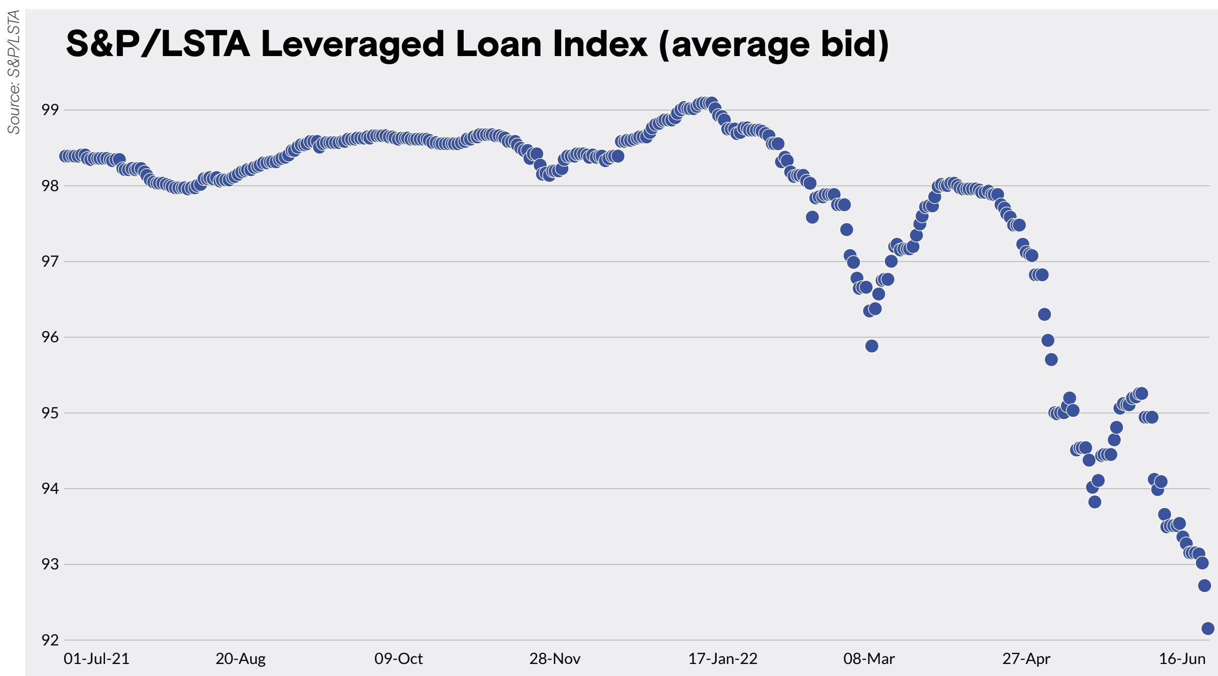
**Bearish**

*Companies without the pricing power to pass on a portion of increased cost to consumers*

**Greatest challenge**

*Concern over a possible recession and a sustained inflationary environment*

**Private leveraged loans have remained one of the best performers in fixed income**




Source: S&P/LSTA

*The US loan market has been on a steady decline, which seemed to be arrested in early June as loans drove past 95 cents. But they ended Q2 on 92.16 — the lowest valuation since August 2020.*

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# Emerging markets

*China provides positives with decompression at play in high yield rating bands*

Emerging market corporate bond supply plummeted to $39 billion in Q2, for the lowest quarterly volume since the first quarter of 2016. The high yield new issuance component was just 18.5%, versus normal levels of around 35%.

Autumn Graham says this reflects how investors were shying away from risk, but points out that Asia was a bright spot, representing 80% of new issue volume.

Risk aversion was one of the big themes in Q2, along with spread decompression. “HY corporate bonds suffered most, with the difference of triple B to double B EM corporate spreads now at the 98th percentile as the market prices in an increasing probability of recession,” she says.

“As the market’s biggest fear turned from entrenched inflation to global recession, commodities plunged from mid-June highs and quickly repriced forward expectations for EM commodity credits that had been the last outperformers due to decade-low leverage levels and strong free cash-flow generation.”

## Emerging market high yield has outperformed US high yield corporates so far this year

High yield emerging market names in the JPM Corporate Emerging Market Bond Index have generally outperformed US high yield corporate borrowers so far this year. And Graham sees positives in China, specifically investment grade names and state-owned enterprises where spreads have widened. These bonds have a differentiated buyer base, and spreads could benefit from incremental policy easing and improved sentiment if US tariffs are lifted.

She also cites non-corporate commodity opportunities in higher quality sovereigns, such as Chile, Peru and India.

more ≫

**Autumn Graham**

Portfolio manager, Schroders

**Bullish**

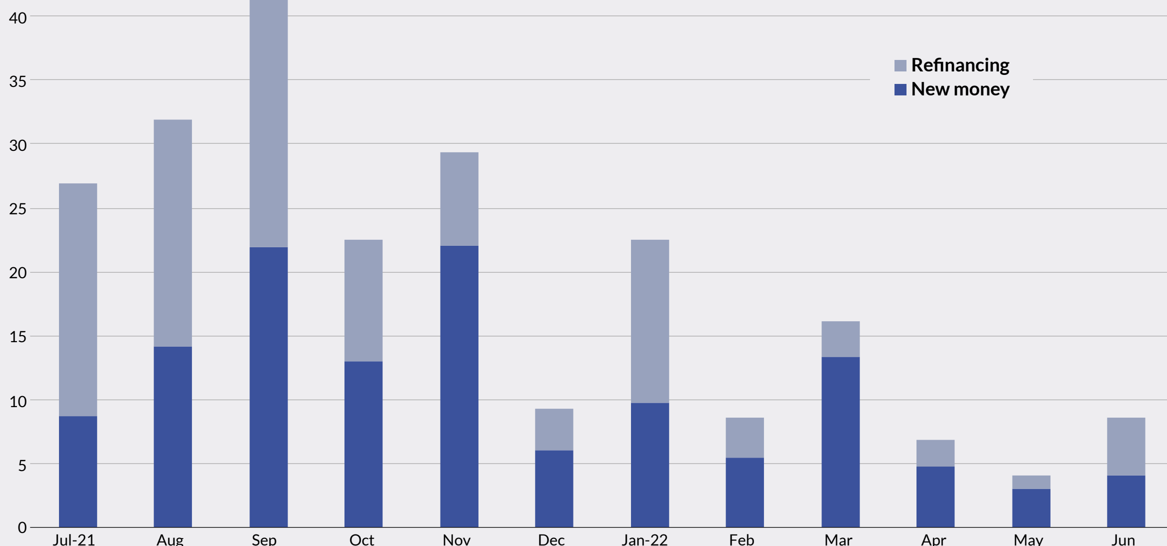
*High-rated China IG corporates and state-owned enterprises*

**Bearish**

*Corporations in high yield countries vulnerable to macro headwinds, such as Argentina and Turkey*

**Greatest challenge**

*Managing around an inflationary regime where treasury hedges do not provide protection against routs in global risk assets*




*Source: Debtwire Par*

*There is a clear opening to buy high yield, with yields reaching 8.46% and some corporate credit specialists favouring bonds over loans at present.*

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# Macro credit

*Peak inflation signals suggest time is ripe to go long in oversold markets*

The case for a tactical rally in credit is growing, with signs peak inflation may not be far ahead and the market looking as though it has largely priced in central bank hawkishness. Investor positioning in recent volatile months has been light or short, while supply/demand dynamics are inverting in the absence of a primary market for bonds and loans.

According to Viktor Hjort, these oversold conditions point towards a round of spread tightening like that in March, when US investment grade excess returns hit 2.5% — more than the whole of 2021 (1.7%).

"Central Bank hawkishness is losing its ability to surprise and the credit market is pricing in even more policy tightening," he says. At the same time, global shipping prices are declining and China is reopening, while US consumer confidence is at the lows which, historically, coincide with the peak of inflation."

As such, although it is late cycle, market risks have started to shift from inflation to growth and from policy tightening to defaults. "Any sign that central banks move towards execution rather than new tightening measures can trigger a relief rally, and it justifies a decompression portfolio bias favouring high rated, liquid, less cyclical assets," says Hjort.

Assets sensitive to central bank moves could thus start to perform, as both relative and absolute valuations are better. There are fewer crowded trades, with those that exist being fundamentally defensive alternatives to lower rated credit.

"Growth will slow but what matters to credit is a recession of the order of more than 8% defaults and unemployment," says Hjort. "This looks unlikely for now as consumers are protected by savings balances and a strong jobs market, while corporates have better than average fundamentals."

**Viktor Hjort**

Global head of credit strategy, BNP Paribas

**Bullish**

*Euro corporate hybrids, non-cyclicals, banks cash/CDS basis, iTraxx Europe July payers, dollar financials, single B rated bonds (versus double B and triple C), 5-10 year IG and 3-5 year high yield*

**Bearish**

*LQD US ETF (relative to five-year CDX IG), dollar loans (relative to dollar high yield bonds), euro high yield cyclicals, iTraxx Europe September straddles, IG dollar yankees*

**Greatest challenges**

*Deep recession, Euro gas crisis*

## Consumers are protected by savings balances and a strong jobs market

Banks have been the worst performers this year in the US and Europe. But their valuations relative to corporate borrowers are wider than March 2020 and capitalisations buffer against slowdown, suggesting a buying opportunity. Similarly, European corporate hybrids were a crowded, ECB-sensitive trade last year, but since then their relative valuations moved to all-time wides. "IG portfolios have de risked exposures and issuers are mostly non-cyclical," says Hjort.

In the US, the cycle is turning against loans — which previously benefitted from being floating rate — as they start to suffer from declining interest rate coverage.

In Europe, Hjort prefers non-cyclical credits over cyclicals. "The prospect of a consumer recession looms as a response to high inflation and the cyclical risk premium in European high yield is low," he says.

Tail risk challenges include the prospect of Russia cutting off gas supplies to western Europe. That scenario favours utilities, which would pass on costs to consumers, over industrials. Meanwhile, buying iTraxx Europe payers remains an inexpensive hedge during summer illiquidity.

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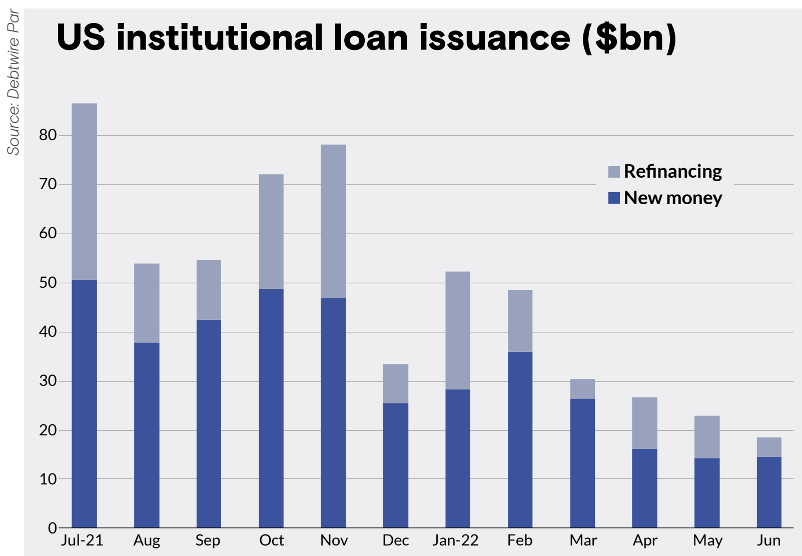


*US new loan issuance has slumped, with yields reaching 431bp as some deals discounted into the 80s.*

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# Investment grade

*There is no need to add risk or go up curves for strong returns in IG*

Financial markets have been hammered this year, but fixed income investors can find solace in a good entry point to go long fixed income without taking on too much risk.

"You can invest in a diversified portfolio with a high single-A to low double-A average rating and get attractive yields because of how steep the investment grade curve is at the front-end up to two years," says Noah Wise. "In the past decade it has been pretty much impossible to do that without going out the curve, or into high yield."

Given the increase in benchmark rates and widening in credit spreads, such a portfolio could generate a roughly 5% yield.

The opening has been created amid one of the toughest periods for fixed income investors.

Using monthly returns, the Bloomberg Aggregate Bond index was down 10.29% on the year at the end of June. This was the first time since the mid-1970s that it dropped by this amount, says Wise. "By contrast, the S&P 500 has been down by this amount about 10% of the time. Although the price decline between the two asset classes has been similar over the past year, this type of decline is much more frequent in equities."

Unlike other areas in credit, investment grade issuance has held up well, because more issuance needed to be done in IG versus high yield, where maturities were extended last year when the primary market was hot. For investors, this has been the best place to source paper, with discounts applied to make new issue more attractive than secondary.

"The market has done a good job of discounting the various scenarios," says Wise. "IG bonds are being appropriately priced, we feel."

Looking ahead, Wise says investors are best off being market neutral so that they can respond decisively when credit spreads take a clear direction. "We are seeing investors with very high conviction macro views taking aggressive positions in different directions. I don't think they have the data to support those views," he says.

more ≫

**Noah Wise**

Senior portfolio manager, Allspring

**Bullish**

*The greater value in public fixed income versus equities*

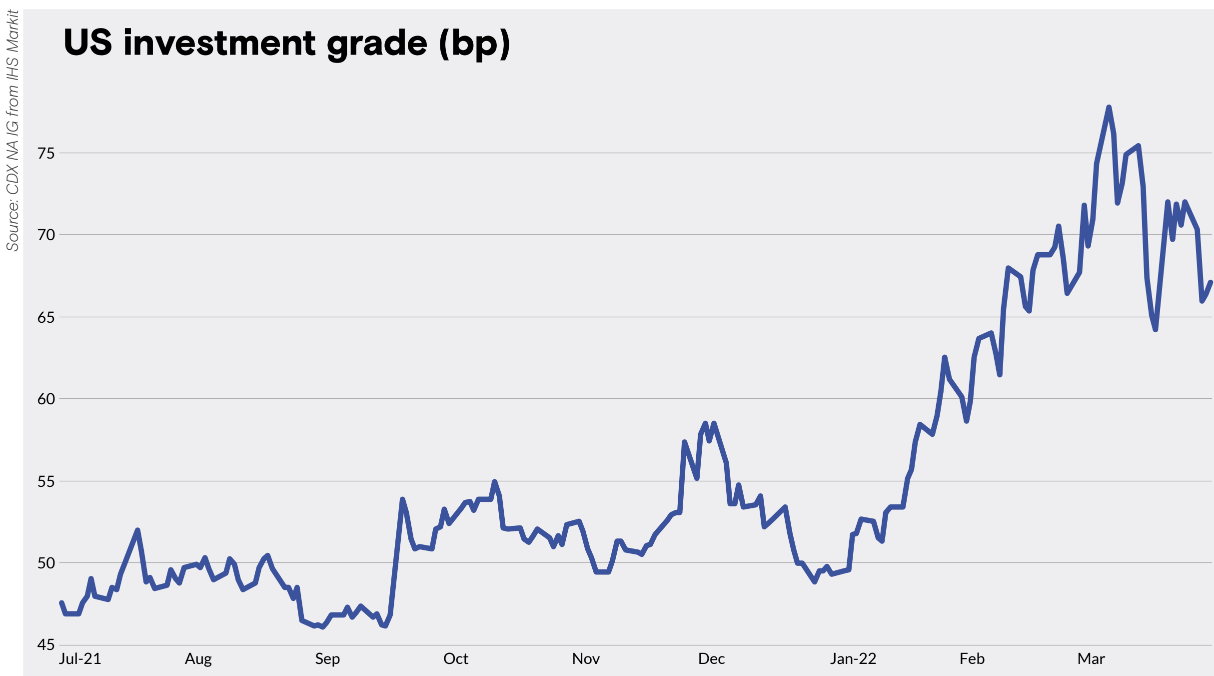
**Bearish**

*Uncertainty on which direction the market will take*

**Greatest challenge**

*Managing around rates volatility and illiquidity. Markets have been manic in recent weeks*

**The market has done a good job of discounting the various scenarios**




*The US IG index burst past the psychological 100bp barrier in June, but has since dipped lower. It has been more vulnerable to volatility than HY this year, doubling from its starting value on 1 January (49.34bp).*

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# Real assets

*Window will open for European CMBS and CRE CLOs*

The nascent European CRE CLO market and resurgence of European CMBS has stalled in 2022. But as deal flow picks up later this year and spreads normalise, these asset classes could be boosted.

Before Russia's invasion of Ukraine in February, a handful of issuers were weighing up their first European CMBS transactions, says Serenity Morley. And at the Global ABS conference in June, European CRE CLOs were all anyone could talk about.

There are different reasons for the interest in securitised assets. "The CMBS market allows sponsors to access capital markets," says Morley. "There were a few lending institutions looking to break into this market in January and they could be tempted to dip their feet back in once the market picks up. The CRE CLO market, on the other hand, allows firms to obtain more leverage on their debt products."

Europe's CRE CLO market opened in December after Starz produced a £219.8 million deal courtesy of Credit Suisse. Momentum built quickly, with several other firms looking to follow this path, but the timing did not work out, as credit markets have suffered.

Morley is optimistic primary loan markets will pick up at the end of Q3. She says retail banks have pulled back in recent months after a productive period in Q1, but the void has been filled somewhat by fund managers lending to each other.

more ≫

**A few lending institutions were looking to break into CMBS in January and they could be tempted back once the market picks up**

**Serenity Morley**

Head of loan servicing, Mount Street

**Bullish**

*The emergence of debt-fund to debt-fund lending*

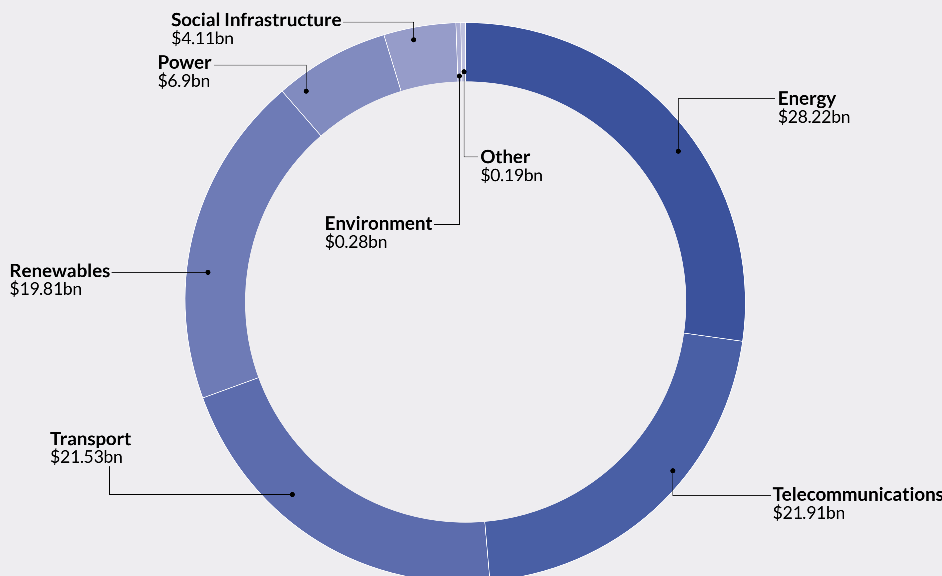
**Bearish**

*The logistics industry and the slow rate of deal execution*

**Greatest challenge**

*Dealing with a multitude of issues — chief among them is inflation*

**Infrastructure loans by sector (Q2 2022)**




Source: Infralogic

*Energy has overtaken telecoms as the busiest sector for primary issuance in Q2. Telecoms loan volumes dropped from $31.99bn to $21.91bn, while energy ramped up from $25.13bn to $28.22bn.*

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# Global high yield

*CLO managers can take advantage of record high yield outflows*

US high yield funds have lately registered the largest outflows since March 2020, according to BofA global research reports, leading to five weeks of consecutive outflows and a loss of 4% of assets under management.

Broadly syndicated loan and bond-flex CLO managers tell *Creditflux* they have stepped in to take advantage of deeply discounted bond prices versus loans and are making use of recent increases in bond allocations after the Volcker rule amendment. Some are buying high quality short-duration bonds at a discount. But if spreads widen further this could negatively impact the net asset value of CLOs.

Jason Horowitz says outflows have been orderly and brought opportunities. Dispersion has been evident in the first half of the year, and he expects this to continue in the next six months. “The sell-off has caused certain bonds to trade well beyond what we think is fair value based on our team’s fundamental analysis, and we’re looking to take advantage of those situations,” he says.

“We’re looking at companies that can generate free cash flow, have appropriately sized balance sheets, have a real reason to exist, and for which we have a good sense of what they will look like once we get on the other side.”

**Jason Horowitz**

Head of high yield bond investments, CIFC Asset Management

**Bullish**

*Idiosyncratic opportunities created by the sell-off*

**Bearish**

*Companies that financed too aggressively during 2021; levered cyclical capital structures.*

**Greatest challenge**

*How aggressively global central banks will remove liquidity*

CIFC hopes to take advantage of the liquidity profile of some bonds by shorting credits that will suffer when markets get challenging.

## Companies will come to market

Global corporate bond issuance reflects market concerns and is down roughly 75% over the same period in 2021. Because most companies issued debt in 2021 and the back half of 2020, they have not needed to come to market in 2022. But at some point they will and, if the market is still challenging, they may need to offer greater discounts, which Horowitz says could create an opportunity.

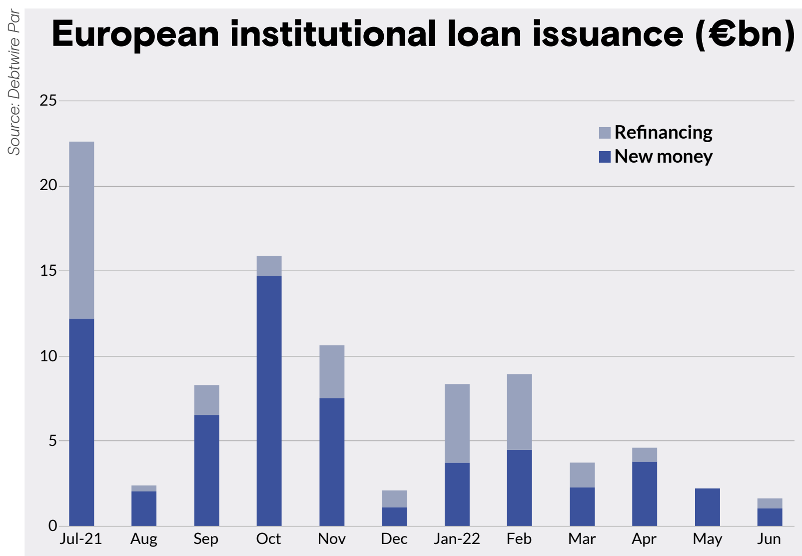
**We believe some ‘zombie companies’ will never grow into their capital structures**

On the flip side, he is concerned about high yield companies that took on too much debt last year and have a slim margin for error. “Some of the LBOs of 2021 during the easy money environment provided by global central banks might not default in the next 12-24 months because there’s no liquidity event, but we believe some ‘zombie companies’ will never grow into their capital structures. We don’t want to own these bonds.”

Over-levered companies are also more likely to struggle with cash flows in a deep recession.

Horowitz says the primary driver of risk for high yield will be central bank activity. “High yield is first and foremost a risk asset. There are other risks out there, including the potential slowdown of global growth, inflation, impact of the war in Ukraine, risk that Putin reduces gas supply to Germany. But I think investors get a little too caught up in the spread of the market today relative to historical levels.”

He says CIFC is more comfortable taking duration risk than cyclical risk. “If rates move significantly higher, there’s a greater likelihood the Fed will be aggressive, which will put pressure on global growth. Then bonds of levered companies tied to global growth are less likely to perform well.”




Source: Debtwire Par

*European loan issuance has dried up. But in the US, the CLO primary market has been functioning across long and short-dated deals.*

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