

Fasten your seatbelts

We summarise key dynamics at play in credit markets and explore how best to capitalise on the bumps that are creating the beginnings of another fertile special situations investment environment.

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Fasten your seatbelts—credit markets are going to be bumpy. Events that once seemed unlikely are all transpiring. Economic and market outlooks are uncertain. An anomaly? For the most part, no. While war and sky-high inflation are certainly not the norm, many dynamics are consistent with conditions that existed for decades before the global financial crisis (GFC), an era that saw a persistent special situations opportunity set. However, there is one critical difference between the two eras: a massive debt market, which the explosion of the leveraged finance market had fueled.

Post-GFC to a reversion to the mean

It seemed as though low rates, a dovish Federal Reserve (Fed), and easy liquidity would persist forever post-GFC. Low cost of capital, borrower-friendly documents, and central banks willing to quell any hiccup in financial conditions with sizable liquidity injections paved the way for massive debt issuance. Leveraged credit markets grew ~150% from US\$1.7 trillion in 2010 to over US\$4.2 trillion in 2022.¹ Then, the unexpected. A pandemic, supply chain issues, and labor shortages, combined with a massive growth in money supply, have led to inflation levels not contemplated in decades. Seemingly behind the inflation curve, central banks have been forced to dramatically raise interest rates, leading inevitably to slowing global growth. These higher levels of inflation, and the impact on interest rates and central-bank activity, lead us to believe credit markets will have to contend with a far less-forgiving borrower environment, one more akin to the late 1990s and early 2000s. Cost of capital for US companies rose dramatically in 2022, driven by an increase in both base rates and spreads.

Throughout the post-GFC period, the yield-to-worst (YTW) on US high-yield bonds averaged 6.6%; in late 2022, it has reached as high as 9.6%.² The market has changed behaviorally as well. Financial missteps are no longer forgivable. Missed earnings, increased leverage and messaging on anemic guidance are now punishable offenses. Cycles and leverage could become significantly more challenging for companies, creating regular pockets of opportunity as opposed to the episodic boom/bust cycle that had become the hallmark of the post-GFC world.

The beginnings of an opportunity set explosion

In less than two quarters, the stressed/distressed opportunity set increased almost 400% from US\$75 billion to US\$300 billion,³ all without a defined

Moving out of the Post-GFC era into a new paradigm

Changing market conditions should drive increased distressed opportunity, as of December 2022

	Late 90s to GFC	Post-GFC	2022 Onward
1. Inflation	2.5% <i>Average CPI</i>	1.9% <i>Average CPI</i>	7.1% <i>Current CPI</i>
2. Fed	US\$814 billion <i>Average Size of Fed Balance Sheet</i>	US\$2.1 trillion to US\$8.8 trillion <i>Growth of Fed Balance Sheet</i>	Fed Intervention?
3. Cost of Capital	10.6% <i>Average High Yield YTW</i>	6.6% <i>Average High Yield YTW</i>	9.0% <i>Current High Yield YTW</i>
4. Globalization	Rising	Peak	Falling
5. Financial Markets	Punish Missteps	Forgiving	Punish Missteps

Distressed Opportunity



Source: Bloomberg. CPI=US Consumer Price Index.

“shock” to the financial system. A recession, seemingly likely in the next six to 12 months, would push this opportunity set to an even larger quantum. A phrase that many had forgotten (or had never heard of) is beginning to resurface: “good company, bad balance sheet.” Prior to 2022, to meet typical special situations return targets, investors were forced to target more challenged businesses through highly labor-intensive and episodic opportunities, oftentimes at higher attachment points. Today, higher costs of capital and tighter financial conditions have limited corporate flexibility. As a result, good businesses that have made mistakes can become stressed, providing very attractive opportunities for special situations investors. **We believe an expanded opportunity set, and the ability to buy good businesses at a discount with process-oriented catalysts to help close the gap, should generate attractive returns while limiting downside.**

Why wait for spreads? Or a recession?

Primary markets have slowed, limiting borrower access to the easy capital to which they have become accustomed, leading to both increased borrowing costs and an increased interest in creative capital solutions.

At the same time, inflationary pressures are materially impacting corporate margins and profitability, leaving more and more companies in need of near-term capital. These are the two critical dynamics today that are leading to primary and secondary opportunities. A recession would expand an already-attractive investment landscape, creating a massive opportunity to identify even higher returning investments in both the primary and secondary markets. However, an attempt to time the bottom is never advisable, or one may miss the boat entirely.

Historic moves in prices and yields have already started, generating investments with uncorrelated, event-driven catalysts, better attachment points, compensation for process, convexity to rates and downside cushion via lower prices.

Conclusion

Today’s markets offer attractive opportunities in credit that cannot be ignored, even when adjusted for highly uncertain headwinds and a glut of leverage. We believe the best risk/reward today lies within a portfolio of uncorrelated and bespoke process-oriented investments, event-driven themes, and names that stand to perform during a recessionary and inflationary environment. We believe it could be prudent to allocate capacity today to be able to deploy capital now and into an accelerating opportunity set.

The Benefit Street Partners – Alcentra platform is one of the largest alternative credit asset managers globally. Find out more:

FOOTNOTE

1 Leveraged credit market sizing includes dollar value of outstanding high-yield corporate bonds and broadly syndicated leveraged loans, in addition to private credit dry powder. Sources: Goldman Sachs Global Investment Research and Preqin.

2 Data for the ICE BofA US High Yield Index sourced via Bloomberg as of December 31, 2022. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**

3 Defined as loans wider than 1000 bps and bonds trading below 80. Source: Bloomberg, as of December 30, 2022.