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INTERVIEW

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The Global Credit Outlook: Finding Opportunities in Public and Private Credit Amid an Uncertain Recovery

While valuations have risen from their March lows, dislocation has created compelling opportunities in both the public and private credit markets.

The COVID-19 pandemic has rattled global financial markets and disrupted traditional sources of credit market liquidity. And while credit valuations have risen from their lows in the initial weeks of the global health crisis, there are still opportunities to be found in the current market and those that will likely present themselves over the coming quarters. In the following Q&A, Mark Kiesel, CIO global credit, and Jamie Weinstein, head of corporate special situations, examine the global credit outlook.

Q: A lot has changed in just a few months, but it appears we're on the road to recovery. Let's start with a high-level overview. How would you assess the current state of the credit markets?

KIESEL: These are unprecedented times to be sure. We're in the midst of one of the sharpest economic contractions since World War II. Second quarter GDP could be down 35% to 40% in the U.S., although the unemployment rate recently ticked down to near 13%.

That's the bad news.

The good news is that we've seen an unprecedented policy response. The Federal Reserve has expanded its balance sheet significantly with lending and liquidity measures of around $2 trillion, including bond purchasing facilities. And since the pandemic began, Congress has passed spending bills totaling nearly $3 trillion dollars – more than twice the amount passed after the 2008 financial crisis.

Growth in the number of COVID-19 cases is also slowing and we're starting to see local economies reopen. We expect to see a U-shaped recovery, rather than a V-shaped one, with both businesses and consumers continuing to exercise caution. That said, we must also acknowledge that there's always the risk of a second wave of cases.

Q: What about credit valuations? How much have they recovered from historically low levels hit in March?

KIESEL: Back in late March, credit spreads were very wide and the credit market was very attractive. We thought that spreads were way too wide given underlying default risks. Credit valuations are still appealing, though not as enticing as they were at that rare moment in time.

We've mainly been focused on what we call the "haves" versus the "have nots." The haves are the companies generating free cash flow, even in a crisis. We're finding opportunities in areas like technology, defense, healthcare, pharmaceuticals, cable, telecom, cell towers, and utilities. Conversely, we're a little more cautious about sectors that really faced headwinds going into the pandemic, such as energy, autos, retailers, and chemical companies.

Q: Could you address opportunities you're seeing in some of the lower-tier corners of the credit markets?

WEINSTEIN: A lot of the lower-quality credit sectors have exhibited detrimental issuance patterns, which took root in the years following the global financial crisis.

Within the investment grade universe, we had seen a significant increase in the issuance of triple-B bonds. In the non-investment-grade space, we saw a lot of growth in the leveraged loan universe. In fact, pre-pandemic, collateralized loan obligations represented slightly more than half of the incremental demand for most leveraged loan new issues over the past few years. The private credit markets have also grown from roughly $80 billion at the time of the global financial crisis to around $1 trillion today.

And that's where the dislocation comes into play: Companies that have been able to access the capital markets came into this environment with significant balance sheet flexibility.

But those that had already taken on significant leverage before the pandemic now have limited flexibility and are severely constrained, and we've seen little to no new issuance of leveraged loans and high yield bonds of late.

That could lead to opportunities for deploying new capital with companies either in negotiated transactions that are anchored and then placed through the public markets – or in private markets where there's relatively less competition than there has been before. With patience, we think we'll see capital deployed into companies that haven't been able to access traditional sources of liquidity. That could be an attractive source of returns down the road, although the pivot to these types of private deals won't likely happen until later in the year or in early 2021. For the time being, we're defensive on high yield in general.

Q: Do you anticipate a wave of high yield defaults as a result of the health crisis?

KIESEL: As Jamie mentioned, there's certainly going to be a lot of dislocation. I think our best sense is high single-digit, potentially even low double-digit default rates within high yield. Ultimately, it could boil down to the labor markets. If we can get people back to work relatively soon, those high yield default rates may stay in the single digits. But there's always the risk that they could go higher if a vaccine takes longer to come online and social distancing policies have to stay in place longer.

Q: As you look at the current market, how do things differ from the global financial crisis more than a decade ago?

KIESEL: When I look back to the global financial crisis, what's striking is just how much the decline in housing prices infiltrated the banking system and caused massive tightening of lending standards.

To put this in perspective, we've seen around $1 trillion in new issuance within U.S. investment grade credit over the past five months. In the second half of 2008, there was less than $100 billion of new issues priced over six months.

The other significant difference is that the Fed in the last two months ballooned its balance sheet with more than $2 trillion in asset purchases, while Congress has passed nearly $3 trillion in fiscal stimulus bills. The magnitude and swiftness of the policy response today vastly overshadow the response in 2008. I think that's why we're seeing markets rebound more quickly.

But here I think we have to make a distinction between the primary and secondary markets. The primary market has improved significantly, and that has largely been a function of the Federal Reserve and quantitative easing.

At the same time, we've seen a lack of secondary market liquidity. As recently as two months ago, market liquidity was the worst I'd seen in 12 years. It has improved, but bid-offer spreads are still wide. No one trading investment grade corporate bonds would call it a normal market like we had back in the fall or summer of last year.

Q: Given all the market uncertainty, do you have any preferences in terms of credit quality and geography?

KIESEL: Big picture, we generally favor developed markets over emerging markets and investment grade exposure versus high yield and bank loans. The U.S. market looks particularly attractive. Over the past six or seven weeks we have seen consistent inflows and the money has been coming in from all over the world – mainly to investment grade U.S. credits.

We are being selective in terms of favoring utilities, defense, telecom, cable, cell towers, healthcare, pharmaceuticals, and technology companies. We want to buy companies where the underlying credit fundamentals are stable to improving and firms can handle a second wave of cases. We're a little more defensive on cyclicals and energy.

Q: Where do you feel the best opportunities are right now?

WEINSTEIN: We see some of the best relative value today in structured products, including both commercial mortgage-backed securities and high quality asset-backed securities. We also see private capital solutions activity really starting to pick up steam. Given the repricing that needs to happen in that space, it will be a while before some of those transactions actually close at levels that we find attractive in the new market reality we are in, but we can tell you that the amount of deal flow within private credit markets is really increasing.

Q: What will be the key to economic recovery going forward?

KIESEL: At the top of the list is the level of global monetary and fiscal response. I like to consider both central bank expansion and fiscal stimulus as a percentage of GDP. If you look at those metrics, the U.S. response has been significant relative to other developed markets and much stronger than emerging markets.

We'll also be monitoring the rate of growth in COVID-19 cases. We need to see that social distancing policies are working. Longer term, of course, we need to see a credible vaccine.

So, it really boils down to how engaged policymakers will be and whether fiscal and monetary support can continue to mitigate shutdown risk.

WEINSTEIN: I think we'll also get signs from earnings revisions and forward earnings estimates. Those provide a good measure of investor and Street expectations. Most companies have pulled back completely from providing guidance for the time being. The extent to which companies begin offering guidance again, and the messaging they deliver about forward outlooks, could be an important economic indicator.

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