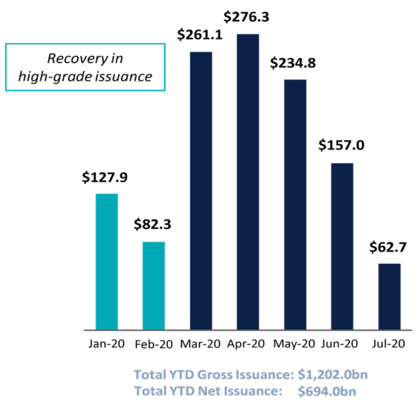
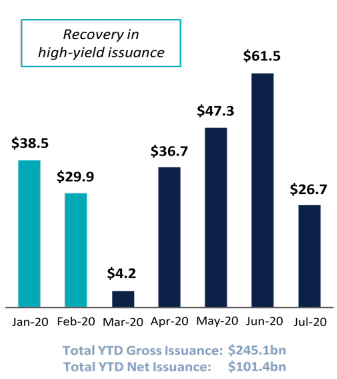
Credit Markets: Liquidity Is Creating a Runway; Illiquidity Is Creating Yield

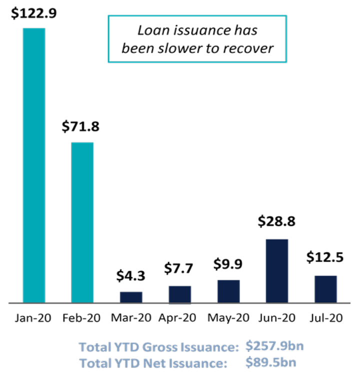
The first several months of the pandemic were marked by selling pressure pushing down on asset classes across industries, even where industry fundamentals would have supported higher valuations.

After several months of Fed intervention, that dynamic seems to have inverted as deteriorating fundamentals are at odds with new market highs. Spreads (the difference between the rate of a given security and a risk-free rate, usually a U.S Treasury) have tightened in the liquid credit markets for several consecutive months. Given the continued high unemployment numbers and the second quarter's record-breaking drop in GDP of 32.9%, one could argue that tightening spreads are not reflecting underlying fundamentals. The illiquid markets are behaving more rationally, with technicals and fundamentals moving in line with each other. The Fed's actions and continued assurances have created a situation in the liquid markets where the Fed has not needed to step in with as much liquidity as it has promised to make available. Instead, market participants are providing funding to companies, which is resulting in an extended default runway. Where the default rate worst case scenario was projected to be double digits in March, it is now tracking to the single digits.

The charts below detail the recovery of the primary markets since the Fed's intervention began in March, through July.







Sources: 1. S&P Global Market Intelligence; 2. JPM Morning Intelligence. As of July 31, 2020. For illustrative purposes only.

Certain sectors that have been hit very hard by the effects of the pandemic and the shutdowns, such as travel and leisure, are not struggling as much as would seem likely because they have been able to continue to access capital. The exception to this is the energy and retail sectors, where defaults are likely to be concentrated.

The effects of the pandemic have also resulted in structural changes to illiquid asset classes. Leverage has decreased, covenants and other structuring features have improved. In addition, certain direct lenders are seeing larger and higher quality companies in defensive industries seeking financing through the private markets.

Liquid Credit

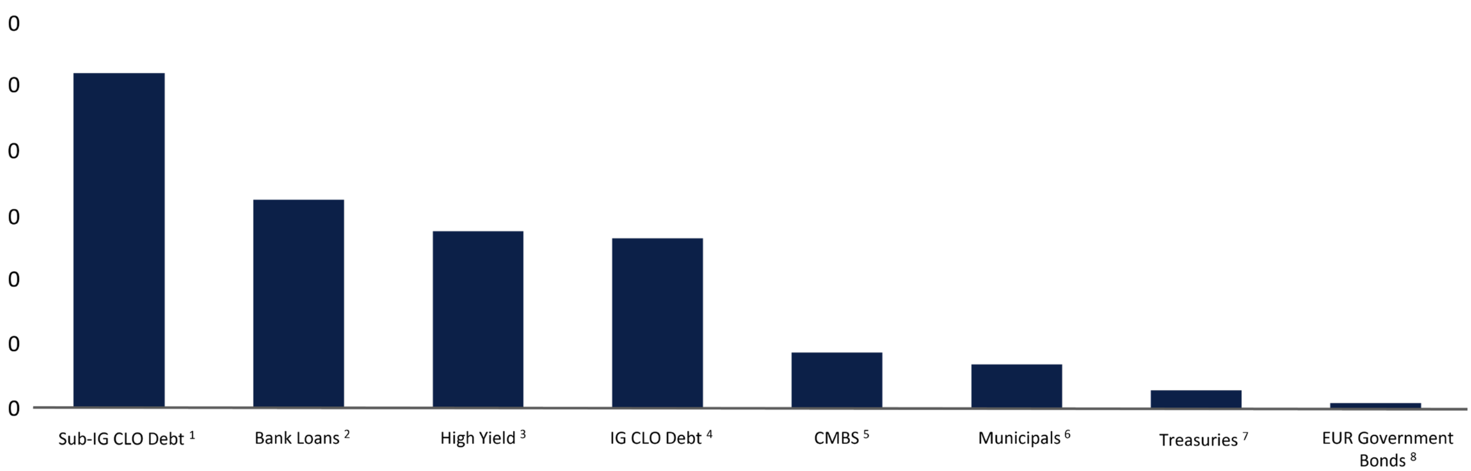
High yield and leveraged loan spreads have tightened but are still wider than they were in January. Credit selection matters as high dispersion continues. Potential opportunities include high-quality credits which may mitigate downside risk and maintaining an industry bias to defensive sectors such as technology, healthcare, and packaging. There may be potential tactical opportunities to purchase "fallen angels" or COVID-impacted issuers that are showing improvement.

Illiquid Credit

Private credit markets are undergoing structural changes that have created more favorable dynamics for lenders who have flexible capital. Fees have increased and leverage has decreased, as competition in the space has eased because managers without access to capital are unable to participate. Another effect of COVID is that there has been an increase in the number of rescue capital financing deals. In Europe, the lack of traditional capital markets' appetite has meant that much larger companies than usual are now accessing capital through direct lending.

The Opportunity Now

As mentioned above, spreads in liquid credit markets have compressed. The illiquid markets, however, are still exhibiting the potential for good yields.



For illustrative purposes only.

Source: ICE BofA Indices, S&P Capital IQ, Credit Suisse Leveraged Loan Index, JPM CLOIE Indices, as of July 31, 20200 Note: Yield to worst data is being presented unless otherwise noted. *Represents the yield to three-year call.
(1) JPM CLOIE BB Index (2) CSLLI (3) ICE BofA US High Yield Index (4) JPM CLOIE BBB Index (5) ICE BofA US Corporate Master Index (6) AB Fixed & Floating Rates / CMBS Fixed Rate (7) ICE BofA Municipal Master Index (8) ICE BofA AAA US Treasury/Agency Master (9) ICE BofA European Union Government Bond Index

A Redefining of the Opportunity Set

There has been a lot of discussion about how the current situation is different from 2008. In 2008, private credit was a smaller industry without many established players. And at that time, banks were confronting the new regulatory requirements and many withdrew from the market. This time, banks continue to recede as lenders and many banks, particularly in Europe, won't take on risk and are not interested in even very large deals. At the same time, the private credit space has grown and matured in the gap left by traditional lenders. The result of these trends has been to push the size of the traditional middle market company past the upper bound of $1 billion. This trend was in place before the crisis, and is now accelerating.

The type of deals is also becoming more creative; it's not just traditional companies that are looking for rescue financing. Hedge funds and specialty finance companies have also realized that private credit firms can be a source of financing to solve liquidity issues. Private credit firms with extensive research and structuring capabilities, as well as flexible capital, are able to enter these new markets.

Conclusion

While the liquid markets have recovered and spreads have tightened, their remains an opportunity set for illiquid credit. For both liquid and illiquid, the determinant of success is strong credit selection capabilities and careful, defensive positioning.