CREDIT MARKET UPDATE: DON'T FIGHT THE FED

As we kick-off the second half of the year with COVID-19 continuing to impact global markets, the macroeconomic environment is likely to play a continuing role in the ongoing market volatility. The virus has wreaked havoc on consumer behavior and spending, which constitutes 70% of U.S. GDP and is likely to be the primary driver of the recovery.[1] Policy changes in response to the outbreak, including Fed actions and government stimulus, are likely to outlast the virus itself, which will continue to affect the investment outlook for the rest of 2020.

In today's markets, the adage "don't fight the Fed" is particularly resonant. The Fed has instilled confidence that it will continue to backstop markets, which has created a "risk-on" posture for investors in both liquid and illiquid debt. Key Fed stimulus programs in both the primary and the secondary market are influencing market technicals. Spreads have tightened for several months and most credit sectors have seen positive performance.

With market volatility continuing, we believe there will be opportunities to find value across both liquid and illiquid credit asset classes. Fundamental credit research and the ability to be very flexible and selective will be critical. Selecting sectors that are less impacted by COVID, and stronger companies in affected sectors while also avoiding mistakes will be the determinant of success.

Below, we review the recent history and potential performance of different credit sectors.

LEVERAGED LOANS

At the start of the year, more than 51% of the loans comprising the Credit Suisse Leveraged Loan Index were trading at par or higher. As of May 29th, that percentage was 0.03.[2] There is potentially value to be found, but markets are clearly preparing for heightened default or downgrade activity. Yield dispersion in the leveraged loan market has increased dramatically and is currently at historic highs.[3] Very few loans are trading close to the index indicated yield. Instead they are spread out in a wide band, which means that credit selection will be paramount not only in finding loans that will perform but also in avoiding ones that may miss earnings or run into other problems that the market will not be sympathetic to.

COLLATERALIZED LOANS

Collateralized loan obligations (CLOs) are a portfolio of senior secured loans that are delineated by tranches and packaged into illiquid securities. They are not usually forced sellers during dislocations because of how they are generally structured, and they do not have covenants that require mark-to-market. In addition, CLOs historically have had a very low and stable default rate. Compared to global corporates, which during the global financial crisis saw default rates as high as 4%, global CLO default rates hovered around zero during the crisis, reaching a high point of 0.25% in 2011 and declining over the last several years to 0.12% in 2018 (the last year for which data is currently available).[4]

During the recent dislocation, while loan spreads widened considerably there were not very many opportunities to buy CLO securities, as holders were not forced to sell. A look at the discount margins, which estimate the average expected return of a variable rate security, over the last six months shows the extent of the dislocation.[5] As of December 31, 2019, the discount margin on BB-rated CLO tranches was at 722. At the nadir of the dislocation in March, the discount margin hit 1455. By early June, it had tightened to 943.[6] In terms of investing within the current environment and recent CLO selloff, managers with robust research capabilities and a selective approach may find attractive opportunities for entry.

DIRECT LENDING

While technicals are currently driving the liquid markets, fundamentals are creating an opportunity in the illiquid direct lending space. The ongoing consolidation of banks and their withdrawal from middle market lending has engendered a shift upwards in the value of the loans and the whole definition of what is "middle market." The size of the market is increasing, and the size of the deals is increasing as companies with higher EBITDA are seeking direct lending partners instead of tapping the syndicated markets.

Direct lending deals in the current market include more competitive pricing, tighter deal structures with more covenants and the ability to select from among more defensively postured companies that have less exposure to COVID-19 and are potentially better positioned to ride out the crisis. However, direct lenders without sufficient capital and footprint may be constrained by their leverage facilities and the need to manage their portfolio, leaving them without the resources to play offense.

CREDIT ISN'T KING - CREDIT SELECTION IS

The crisis driving the markets is challenging, rapidly changing and above all, uncertain. On the positive side, a very committed active Fed has shown its colors and the markets are responding. But the measure of success will be the result of solid research and the ability to both pick investments that perform and avoid investments that struggle.

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1 Federal Reserve Bank of St. Louis. As of Q4 2019
2 Credit Suisse Leveraged Loan Index as of May 29, 2020. For illustrative purposes only.
3 Credit Suisse Leveraged Loan Index as of May 29, 2020. 87.3% of loans are trading at +or -1% Yield 3YR from Index. For illustrative purposes only.
4 S&P Global 2018 Annual Global Leveraged Loan CLO Default And Rating Transition Study. June 19, 2019.
5 Discount margin is the spread (a security's yield relative to the yield of its benchmark) that equates the security's future cash flow to its current market price.
6 As of June 12, 2020. Source: Bloomberg, J.P. Morgan CLOIE.The J.P. Morgan Collateralized Loan Obligation Index (CLOIE) is dedicated to tracking the U.S. dollar-denominated broadly-syndicated, arbitrage CLO market. The CLOIE is not tradeable and aims to enhance market transparency and act as a potential total return benchmark. Represents discount margin by rating for U.S. dollar-denominated post-crisis broadly syndicated CLOs. For illustrative purposes only.