FOCUS AMONG THE CHAOS: A LOOK ACROSS THE CREDIT UNIVERSE

We are living in unprecedented times as COVID-19 continues to wreak havoc on our daily lives, the economy, and the global markets. However, market dislocations also present an opportunity to strategically source credit. The recent market volatility has been incredibly broad-based and indiscriminate. This may create opportunities for active managers with flexible capital to make prudent investments at attractive entry points. Below, we review three asset classes in light of the recent selloff.

The initial cut was the first emergency rate decrease since 2008, and with rates now near zero, we are back to rates not seen since the GFC. The 10-year U.S. Treasury yield, which had already fallen more than 150 bps from 2.58% since the end of 2018, broke through its 1.00% floor.

HIGH YIELD CREDIT: SECTOR SELECTION MAY REWARD INVESTORS

Up until the second week of March, sub-investment grade credit (high yield) had been trading with some semblance of normalcy, with active two-way trading and good volume. More recently, high yield credit spreads reached levels that haven't been seen since the global financial crisis. As depicted on the St. Louis Fed website, high yield credit spreads over Treasuries have nearly tripled in a month, rising from 3.6% on February 19th to 10.1% as of last Friday, March 20th.

Some industries are much more exposed than others to the challenges and disruptions stemming from COVID-19. Industries like transportation, automotive, energy, and leisure are facing formidable challenges, whereas industries like healthcare, technology, and media/telecom are relatively insulated from ongoing disruptions. Right now, all sectors are being sold with little discernment, which sets up favorable opportunities in defensive sectors that are being unfairly punished.

COLLATERALIZED LOANS: IT'S A WAITING GAME

Despite being one of the more turbulent corners of today's credit markets, there are some attractive relative value opportunities in CLO debt and CLO equity. (CLO debt is treated like a bond and offers coupon payments; CLO equity doesn't pay cash flows but instead offers ownership in the CLO in the event of a sale.) Within CLO equity, there's paper that had been trading at 15% rates of return at the beginning of this year and is now being marked at 22% RoR.

Within CLO debt, there's triple-B paper whose yields have risen 200bps and double-B paper with yields that have increased 400bps during the month of March. Much of this paper has been deservedly marked down for issues and uncertainties that have yet to play out; however, there may also be attractive buying opportunities. The difficulty for investors is that the paper is being marked but there are no willing sellers at current prices.

DIRECT LENDING: IT'S ABOUT SIZE AND SCALE

In private credit, it's been very quiet, not surprisingly. Lenders that don't need to bring deals to market are sitting tight. Pricing is just too volatile and there are too many uncertainties about what the future will bring for potential borrowers. However, there are a number of interesting developments in the US and EUR direct lending space. High-quality companies have been reaching out to direct lending and special situations teams requesting quotes on large-scale, short-term liquidity facilities to help shore up their balance sheet and weather these turbulent times. As many banks have curtailed new loan issuance, there are potential opportunities for non-bank lenders with size and scale to step in and fill the void.

THE BOTTOM LINE

As in all dislocations, the challenge is to find opportunities at the right entry points before the disruption resolves. In this case, markets are likely to remain volatile until the virus is contained. However, it has taken just days for central banks and fiscal policy makers to implement significant measures to help avoid a global financial crisis-style credit crunch. With such large stimulus, the rebound, when it comes could be sharp.