Embracing the New Normal in Credit

A Q/A with Mark Gatto and Greg Margolies

We recently sat down with Mark Gatto, our co-CEO, and Greg Margolies, Partner and Head of Markets at Ares, to discuss the macro factors affecting the credit markets over the last six months, and what the potential is for more volatility going forward. Our alternative credit lens shines a light on some surprising ways in which these lenders have been active participants in pushing the recovery forward and what this means for investors.

Are we on the road to recovery, or will there be more volatility to come?

Greg Margolies:

I think the Fed did an amazing job of creating liquidity in our markets, which has smoothed things out and created access to financing that has prevented an avalanche of defaults.

I do think there will be a lot more volatility in front of us, but it feels like we are through the worst of it. And our markets, sources of private capital like ourselves, have really done a great job of getting these companies liquid, helping them get to the other side. There will be a lot of volatility, whether it be due to the pandemic that's still around, whether due to the election or geopolitical issues, but we're on the right track. And that volatility actually, over the course of the next six or 12 months, plays well for what we do for a living, in terms of taking advantage of inefficient markets. But it does feel like we're heading in the right direction.

Mark Gatto:

Yeah, I would agree. And I think one of the things that people underestimate is how healthy these companies were coming into the pandemic. And then when you layer in the support that the government has given, it's really given them a pathway to get through this and come out on the right side.

Are there any downside risks to the liquidity the Fed is pumping into markets?

Greg Margolies:

Well, the good news is that Chairman Powell has said that he's keeping liquidity flowing for the foreseeable future because the economy is still uncertain and mostly because unemployment is still quite high. At some point in time, the Fed will be forced to take out all of the liquidity it has put in, and that will create a lot of uncertainty and volatility in our markets. There's the potential for inflation in the future. And there's potential for a reset of risk premium and spreads as the Fed takes the capital out of the system. But it feels to me that we are an easy one-to-two years away from that. And so, we're going to have a continuation of these markets for quite some time before the Fed is even able to start taking capital out of the markets.

What's the potential impact of the election, on both the credit markets and the economy?

Greg Margolies:

As far as volatility going forward, I think we are in for an election that is going to have a lot of uncertainty, which will unnerve the market. However, I think the Fed is going to keep doing what they're doing regardless of who the president is. It's really more a question of GDP and unemployment.

What's going on outside the US?

Greg Margolies:

The direct lending and the self-originating markets over in Europe are what the U S was 5, 10 years ago, because the banks have really pulled out. There aren't as many players in there that can step in, in size. So, we think there's a great opportunity set still going forward in Europe to do what we do in terms of alternative credit and direct lending. We also think there's a tremendous opportunity for direct lending opportunities, whether it be special situations or performing companies in Asia to invest in, especially as most of the banks there are focused on the larger conglomerates, resulting in a middle market that is tremendously underbanked.

What role does private credit play in the recovery?

Greg Margolies:

If you think about it in most other downturns, the banks were the people who stepped in to create liquidity for companies and individuals. And if you look at it today, the banks have been notoriously quiet, right? Both for middle-market companies, as well as large companies. But also for consumers. They really haven't been providing the capital that people need to get the system going again. This has meant that direct lenders have really been putting capital into the system for growth, for acquisitions, or just plain old refinancing.

The non-bank private lending market has played a huge role in getting liquidity into the marketplace. And I expect that to continue. The difference for a company in working with a private lender is that they aren't dealing with a huge syndicate – they partner with one or two lenders that can get them through to the other side. Speaking from our experience, in the handful of instances where we've had companies that were exposed to the pandemic, we work with them and we would work with the sponsors to make sure those companies are set for the foreseeable future. They're still paying interest. They've got the liquidity. They have flexibility. And most importantly, they're still paying their employees and they're still operating. It's been a pretty interesting concept to see how all this plays out, and I think private lenders are playing a much bigger role than most people would've expected.

Mark Gatto:

Certainly, in this market, liquidity is the name of the game here, right? If you have liquidity, you can get through it. If you don't, you're going to have some problems and having a good relationship with your lender and your lender having a good balance sheet is critical to weather this storm. We certainly thought it was going to be catastrophic when it first happened. And fortunately, it hasn't been. You make a great point about the big banks. You don't hear anything about them in this environment. They're not in the headlines. You don't hear any of the CEO's talking about what they're doing to help the economy in the same way that they did in other markets where the consumer and businesses were in trouble. It's very interesting how, what seemed to be alternative, in many respects it's now mainstream.

Greg Margolies:

It's true because it's not only lending to corporations, it's lending to specialty finance companies that get capital into the consumer's hands. Whether credit card asset backed securities, or auto asset backeds, they've dropped like a stone in terms of new issuance. And the way that people are getting money and liquidity into the hands of the consumer is actually the middle-market companies being financed by folks like us. So, the whole game has changed in terms of how liquidity is being put into the system and into consumer's hands. And so much, as we figured out, so much of the economy is also driven, not only by employment, but by consumer confidence. And we're playing a pretty big role in making sure that stays pretty strong.

There was a lot of expectation that defaults would be huge. Why hasn't that happened? Will it?

Greg Margolies:

It's really been fascinating. Consensus was there was going to be a huge spike in defaults. But what's happened is that the high yield market has been so liquid because of what the Fed is doing, and because that implicit put that people have to the Fed, that they're financing everything. They financed restaurant chains and health club chains and movie theaters and cruise lines. All of which have been really hit hard due to the COVID pandemic. And in any other circumstances, you would have had a much higher default rate because those companies would have run out of liquidity and would have defaulted.

Defaults are up, but they're really in three main industries. They're in retail, not surprisingly, commodities, also not surprising, and telecoms, which is a little surprising. I think going forward, you will see defaults increase, but I believe it's going to be contained mostly into the retail consumer and commodity space.

Mark Gatto:

Those are industries that we typically avoid because of the cyclicality of them and the commodity link to those assets. Another aspect of the private credit transactions that we do is the comprehensive nature of them. We source those transactions and negotiate them, structure them, get the covenants that we need, monitor them on a daily basis, have the relationship with the portfolio company, with the private equity sponsor. This really puts us in a strong position when it comes to seeing or anticipating potential problems, being able to address them and work with our companies to get through them. Because that's the name of the game here, is just how do you get through this? How do you get to the other side, when we believe the economy will rebound and we'll be through this pandemic?

Structured credit suffered greatly in March and has been slower to recover. What's happening there?

Greg Margolies:

It was kind of a wild ride to be on. Collateralized Loan Obligations (CLOs) hung in there, the prices for CLO mezzanine and equity, even after equities dropped, even after the loans and high yield market dropped, and then two or three weeks later, the CLO market cracked. And it went down 50%, in some instances. And it stayed there, even as the market started recovering, the CLO market was left for dead. But that did two things. One, it made you go back in and reassess every investment you made to make sure that they were still going to be money good. And we did that, and we felt very comfortable with our portfolio, so we weren't sellers at the bottom, but rather we went in to see, can we buy? And it was a semi-liquid market. So, there's very few trades happening because they were mostly mis-marked relative to where someone would actually transact.

We tried to pick up some names and we did. What we've seen since then is that gradually the market is recovering. Slower than the liquid markets, but definitely getting back. And so much of that today, the mezzanine market in CLO was almost back to where it was, exactly where it was, pre-pandemic. The equity CLO market is still lagging.

What we're doing is selling into the strength, into the mezzanine market to buy into the weakness of the equity CLO market. And that dynamic allocation is one of the benefits, but also one of the benefits is our ability to wait through that mark-to-market volatility and wait for those prices to come back up, because they were fundamentally good companies.

Mark Gatto:

I don't think people appreciate how these structures work and how they have the ability to kind of self-heal over time and the way the structure and the waterfall works to protect the investment. That's been proven in this environment. And then on the other side of the equation, we have the liquid markets that really rebounded very, very quickly, I think, to the surprise of many. And today, they're pretty much flat, I think on the year.

Is there still value in the liquid markets?

Greg Margolies:

Well, I think you almost have to pick what you're talking about, relative value on spreads or absolute value on total yield. On an absolute basis, yields are not exciting but that's only because you look at where the risk-free rate is. On a relative basis, well, it's still, the fact that you can't get yield anywhere in this marketplace and the fact that both the loan and bond market, the spread that we have today, if you look at it based on history, it's actually relatively wide compared to where spreads have been historically. So, I actually think you're getting paid well for the risk you're taking. I don't know, from a spread basis, everyone just wakes up and says, "Gosh, the yields are low." But that's because the yields are low across every asset class.

To get back to volatility, those are buying opportunities and the ability to reposition portfolios. We still think that there's a fair value in the loan and bond marketplace, especially at the spread levels. And we're trying to take advantage of good companies with good balance sheets that have limited impact in this pandemic, and there's still a bunch of them out there to take advantage of. We may not buy every day in the marketplace, but when you see markets down, half a point, a point, it's a good opportunity to buy the high-quality franchise companies. That's like discounts because those are still giving you good yields and good risk adjusted returns.