VÄRDE

Värde Views: Credit Market Update

Highlights from first quarter 2021

April 2021

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INTRODUCTION

With markets responding to the global vaccine rollout and the path to a new normal beginning to take shape, Värde Partners' CIOs Ilfryn Carstairs, Giuseppe Naglieri and Brad Bauer provide their thoughts on the economic conditions affecting the investment landscape, the evolving opportunity set and the outlook for credit markets as Covid-related tail risks continue to diminish.

Please note that these views were authored at the end of Q1 2021 as part of our quarterly communication with investors and may have evolved since the publication of our first quarter 2021 letter.

OVERVIEW

Strong "risk-on" environment

The first quarter of 2021 proved to be a generally strong one for risk assets. Tail risks around the pandemic continue to reduce as vaccine efficacy has held up and the global rollout continues, and policymakers have remained very accommodative even in the face of better data and prospects.

The strong desire to reach for return and yield we expected coming into 2021 was apparent as investors processed this increasingly positive medium-term backdrop; this despite several dark spots still immediately in front of us in the health crisis.

This mood manifested in some headline-grabbing moves and events during the quarter, particularly in equities and several more esoteric asset classes. Credit was strong, but much less frothy and headline-worthy. Indeed, the disparity between equity and credit is stark in many parts of the market and even within the same capital structures.

Perhaps driven by the much touted "retail flows" into beaten down sectors, several equities in these parts of the market have recovered to levels where both their market capitalization and enterprise value is higher than pre-Covid, while their credit continues to trade at significantly wider spreads than pre-Covid.

We believe this dynamic offers opportunity, particularly in the credit of large corporates that continue to resolve significant disruption from the pandemic.

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Contradictory assumptions

A key risk we flagged coming into 2021 centered around interest rates, and specifically rates and inflation expectations as the market resolved its (to us) contradictory assumptions. On the one hand market prices already were looking through to a strong economic recovery during 2021; on the other hand, longer-term rates had barely moved from pandemic lows.

This contradiction was clearly in focus during the quarter, and there were significant moves higher in medium- and long-term rates as well as much discussion around the path of Fed policy. For credit markets this led to much more muted performance in absolute returns than spreads and some mild patches of volatility.

Where to from here?

Consistent with our outlook at year-end, we see a strong backdrop to the economy and more evidence that there will be a material demand rebound in the second half. There have been no major signs of economic or consumer resilience or resolve falling away in the meantime. Rates remain the biggest risk factor to markets in our view, away from the obvious of a step change in the pandemic. Having said that, it seems to us difficult for rates to move substantially higher in the near-term given the sharp moves of Q1 and the still subdued economic environment.

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Policymakers have also been happy to allow this adjustment without any intervention, given it has led to little volatility, but would likely not tolerate another large move from here in the next couple of quarters and remain generally in a very interventionist mood. A mixture like this: strong and strengthening economic forecasts, accommodative policy and rates in control would continue to provide a very strong underlying push to markets and, as we have seen, combined with bullish risk sentiment and ample liquidity, can lead to a greater reach for returns.

Of course, much of this is in the price, including froth in many parts of the market, so we don't see a simple story of earning returns from here. We can be positive on the backdrop and still uneasy on the risk environment. That said, the story under the surface of the credit markets is much more nuanced than the headline strength suggests. The wide range in outcomes by country and industry and the uncertainties created by a world going from sudden stop to sudden start economically continue to create strong opportunities for fundamental credit selection.

INVESTING OUTLOOK

As we reflect at the end of the first quarter, our views on key elements of the investing outlook remain largely intact from year-end 2020.

Strengthening economic backdrop

The value of backward-looking economic data remains limited in this period of transition for the economy through vaccine rollouts. However, the general trend of economic resilience continued, despite many parts of the global economy remaining closed or restricted by the pandemic. In the US and Europe, for example, PMI indicators continued to register levels indicating solid expansion.

Fiscal stimulus remains a very important driver of both the near-term and forecast economic outcomes and is underpinning revisions higher in global growth expectations. Fitch revised upwards its 2021 GDP growth estimates for the U.S., China and the global economy. Europe looks set to grow, but lag other major economies on the path out of recession once again, with a slower ramp-up in vaccinations and less overall fiscal stimulus both weighing on its relative prospects; another reminder that there will be a range of different cycles as we emerge from this period.

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Constructive health developments

Despite a difficult couple of months ahead in many parts of the world, the news on the health front in 2021 remains supportive of our view that there is a strong likelihood of a return to a manageable new normal this year. We believe unblocking logistics and access to vaccines will be a major driver of health outcomes from here. While these are not trivial problems, and are driving major differences in health outcomes by country and region as well as some political conflict around vaccine nationalism, they are things that can largely be solved by the passage of time.

Stimulus: haves and have-nots

As noted, fiscal stimulus continues to be strong and generally at the high-end of expectations. In previous quarters we may have described this as "surprising to the upside", but in truth it is no longer particularly a surprise. The underlying premise that policymakers will continue to use and aggressively expand the tools at their disposal in market and economic downturns seems to us now a basic truth of the market for this cycle and indeed for the future, at least until there are more significant consequences to the policies.

This truth seems likely to forestall for much longer any of the debates, prevalent in recent cycles, around austerity or tapering. Again, this will be an area of haves and have-nots, with the U.S. leading the way in both size and continuity of stimulus, while Europe lags and is more likely to snap back to orthodox policy. The main consequences in focus will be around inflation and whether the building froth in markets leads to systematically significant asset bubbles. While we are not there yet on either front in our view, these are key risks to monitor this year.

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More predictable politics

Unsurprisingly, politics became less volatile after the transition of the U.S. presidency and most of the market impact came from more regular political events such as the debate around stimulus in the U.S., while China / U.S. relations thawed slightly with a meeting between the two nations. Going forward, U.S. economic policy around tax and further stimulus will come into view quickly. More medium-term, the eerily familiar circumstances in Europe – a slow and unequal recovery, entrenched orthodox economic views and key upcoming elections with populist opposition – brings back some prospect of a sequel to Eurozone instability.

LOOKING AHEAD TO THE OPPORTUNITY SET

In Q4 2020, despite the broad market rally, we were confident that public markets would offer much to do over the coming 12 months, particularly in highly disrupted sectors of corporate credit and other traded credit markets. We believe that view has so far been validated through the end of Q1.

No doubt, normalizing credit markets continue to chip away at the breadth of the public market opportunity set we have seen over the past year. Yet, we believe good value and depth of opportunity endures in portions of credit markets and one must look beneath the surface of market averages to uncover it.

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The persistence of wider spreads, and heavy issuance, in the credit of several large issuers in Covid-affected sectors such as airlines and cruise lines, despite the recovery in public equity values, continues to represent a major class of opportunity in our view. There are several others though in our global research universe. For example, European bank credit is a space where credit spreads remain wider while bank credit quality has improved and survived the test of the pandemic economy. The general new issue credit market remains in focus too as the risk of higher interest rates likely pulls forward some supply from issuers seeking to capitalize on current levels to shore up liquidity and extend maturities.

Notably, the very dynamics that have narrowed the opportunities in public markets have led to an expansion of activity in private markets, as the reduction of uncertainty brought about by medical developments has driven both supply of secondary opportunities and demand from borrowers now looking to fund growth plans or refinance.

While strong valuations amid the recovery leave us cautious on both equity-linked risk and non-performing situations, we believe the progression of the cycle brings greater opportunity and better relative value in bilateral lending to performing borrowers lacking capital markets access or seeking customized capital solutions. Stimulus is having much less impact on the pricing in these parts of the market. This approach is familiar to us, as it aligns with how we have navigated past cycles; as clarity on the economic trajectory increases, so too does our conviction in ramping up private market investing. We observe scalable opportunity and attractive relative value in lending themes such as U.S. housing, Asia Pacific corporates, India real estate, and global specialty finance.

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Across this diverse set of themes, we see common elements as key drivers of value for lenders: high demand for credit from performing borrowers and assets, a constrained supply of that credit, and a supportive fundamental backdrop which has not yet been fully reflected in the price for capital. We favor those situations where we can structure bespoke lending solutions for borrowers, which potentially offer both attractive spread, and solid downside protection.

About the Authors

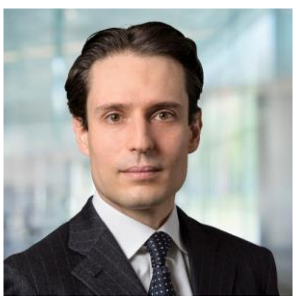
Ilfryn Carstairs
Partner, Co-Chief Executive Officer and Chief Investment Officer

Ilfryn Carstairs is a Partner, Co-Chief Executive Officer and Chief Investment Officer. Based in Singapore, he chairs the firm's Investment Committee and leads the global investment strategy.

Ilfryn joined the firm in 2006 in London, where he played a key role in building Värde's team and business in the European region. Through his career with the firm he has invested across a wide spectrum of financial assets ranging from corporate restructurings and liquidations to more actively traded opportunities. Ilfryn was named Partner in 2011 and served as Co-Head of Corporate and Traded Credit managing Värde's liquid investing activities globally before being named Co-Chief Investment Officer in 2017 along with his move to Singapore. He assumed his current role as Chief Investment Officer and Co-Chief Executive Officer in 2020.

Before joining Värde, Ilfryn worked for Deutsche Bank London in the Financial Sponsors Group, and Pacific Equity Partners, an Australian leveraged buyout firm.

Ilfryn received a B.C. with First Class Honours from the University of Queensland, Australia and an M.B.A. from INSEAD, France.

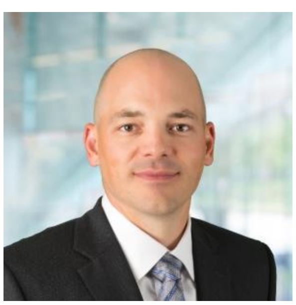


Giuseppe Naglieri
Partner and Deputy Chief Investment Officer

Giuseppe Naglieri is a Partner and Deputy Chief Investment Officer. In addition, he serves as Global Co-Head of Corporate and Traded Credit and a portfolio manager of the firm's global liquid investments. He is a member of the firm's Investment Committee. Based in Minneapolis, he joined the firm in 2009 and was named Partner in 2016.

Prior to joining Värde, Giuseppe worked for Goldman Sachs as an Associate in Fundamental Strategies. Prior to Goldman Sachs, he worked at JP Morgan in Investment Banking, focusing on telecom, media and technology.

Giuseppe graduated from Bocconi University with a B.A. in Business and Finance.



Brad Bauer
Partner and Deputy Chief Investment Officer

Brad Bauer is a Partner and Deputy Chief Investment Officer. He is a member of the firm's Investment Committee. Based in London, he joined the firm in Minneapolis in 2007, was named Partner in 2013, and has led the firm's London office since 2019.

Brad has held numerous leadership positions throughout his time at Värde, including oversight of all non-investing functions. Prior to that, he was involved in managing the firm's Corporate and Traded Credit team. Brad's experience spans an array of industries and spectrum of credit markets.

Prior to joining Värde, Brad held senior investing and portfolio management roles focused on distressed debt and credit trading at both Deephaven Capital Management and Ameriprise Financial, Inc. Prior to Ameriprise, he worked for U.S. Bancorp Piper Jaffray in the Middle-Market Mergers and Acquisitions group.

Brad received a B.S. in Finance from Iowa State University, where he also competed on the varsity golf team. He earned his Chartered Financial Analyst (CFA) designation.

About Värde Partners

Värde Partners is a leading global alternative investment firm with roots in credit and distressed. Founded in 1993, the firm has invested $80 billion since inception and manages more than $15 billion on behalf of a global investor base. The firm's investments span corporate and traded credit, real estate and mortgages, private equity and direct lending. Värde employs more than 300 professionals worldwide with offices in Minneapolis, New York, London, Singapore and other cities in Asia and Europe. For more information, please visit www.varde.com.

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