Värde Views: Credit Market Update

Positive outlook with heightened risks

November 2021

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INTRODUCTION

With market volatility driven by the surge of the Delta variant, U.S. politics and other factors, amidst a continued global vaccine rollout and positive advances towards a new normal, 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.

Please note that these views were authored at the end of Q3 2021 as part of our quarterly communication with investors and may have evolved since their publication.

POSITIVE ECONOMIC OUTLOOK WITH SOME HEIGHTENED RISKS

The third quarter delivered a more nuanced market environment than that of earlier this year. While market metrics were generally solid, it was not the "everything rally" seen in the first half of 2021. Instead, dispersion within markets returned as several factors led to higher volatility and changed expectations of market participants.

Four major themes were the most important drivers of this shift:

1. The Covid Situation: case growth and behavioral change across the world from the Delta variant ("Delta") has begun to cast doubt on the recovery trajectory and growth outlook of economies.

2. Rates and Inflation: debate around the persistence of inflation has grown louder as the inevitable Fed taper comes into clearer view and the real-world impacts of supply shortfalls flare up.

3. U.S. Politics: protracted wrangling over the infrastructure spending bill and the potential for yet another round of brinksmanship around the debt ceiling (though we note it appears substantial progress has been made in recent weeks).

4. China: increased uncertainty from elevated geopolitical tension between China and the West and the impacts of a much more aggressive regulatory stance taken by China against certain domestic companies and industries.

Stepping back into the bigger picture, we believe the near- to medium-term outlook remains broadly positive, but with some significant risks to monitor.

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On the positive side, policy remains accommodative and policymakers seem in a mind to keep it that way even as some parts of it inevitably roll back. Vaccine efficacy, the recovery linchpin, continues to allow economies to move from lockdown to endemic management in their approach to Covid, supporting a rebound in economic expectations. Consumers' balance sheets are healthy, having saved a lot through lockdowns, and investors are flush with liquidity and dry powder.

Why the somewhat moderated view?

The continued distortions in the world economy as it reopens are a source of some concern. Wages and labor shortages remain in focus globally and European energy prices have been a new warning sign, which is an issue with potential to worsen and spread to other geographies as winter in the Northern Hemisphere progresses. Distortions like these can be both a drag on growth and a driver of more worrying inflation.

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More near-term, the perplexingly regular dance around the U.S. debt ceiling deserves at least some attention, even as it seems highly likely that reason eventually will prevail and the can has been kicked at least into December.

Finally, the developments in Chinese regulatory policy have been unpredictable, very significant, and signal more appetite for a combative stance against certain industries than we have previously seen. While we don't subscribe to the scramble to call the events around the property sector and China Evergrande a "Lehman moment" so quickly, we equally see the general situation as opaque and, if it deteriorates further, with potential for impact beyond China.

To be clear, the net of all this remains a positive economic outlook with some very strong tailwinds. However, with so much positivity factoring in the general price of assets, having an eye on the potential negatives is very important, especially if some develop as clearer negatives potentially causing the balance to shift further.

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ROBUST RISK ENVIRONMENT

As we reflect on the last three quarters, our views on key elements of the investing outlook have remained generally consistent through the year.

Strong recovery with areas to monitor

Economic fundamentals continue to point to a generally strong recovery in demand as the world emerges from the pandemic. While this rebound has perhaps been elongated by the impact of Delta, overall forecasts for economic growth remain solid, underpinned by fiscal stimulus, a strong and wealthier consumer, and pent-up demand.

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However, there are now more causes for concern, with two of those noted above being the most important to monitor for their impact on the economy in our view.

First, supply chain issues continue to create acute impacts on the cost and availability of some important economic inputs across various sectors and countries. The sharp rise in energy prices across Europe is a key recent example, and one with more potential for systemic impacts on growth than others, particularly if it is mirrored in other economies through the coming northern winter or leads to quicker monetary policy action.

Second, the stark change in China's policy environment has clear potential implications for economic growth there and beyond, particularly as the flow-through impacts on the important property sector resolve.

Shift towards "new normal" despite Delta

The Q3 Covid story was dominated by the global spread of Delta. While cases spiked, it also provided a test of the "new normal" approach to Covid management, with governments pushing for both high vaccination rates and the phased reopening of economies.

While we are still some way from "old normal," more governments have adopted this playbook, including countries where full eradication was the prior policy stance (e.g., Australia and Singapore). The general conclusion that this can work without causing a spike in hospitalizations seems to be standing the test, except in areas with low vaccination rates.

The upcoming rollout of booster shots, expansion of approvals to certain children under 12, and the likely general tailoring and improvement of vaccines and therapeutics should further bolster Covid management. The key negative wildcard would be a more potent mutation of the virus.

Strong stimulus and monetary policy tailwinds

While the passing of the latest U.S. fiscal stimulus bill has not been as smooth as hoped, the general level of fiscal support in the U.S. and globally remains significant. Even though the marginal impacts of this support will begin to tail off and perhaps turn around over the next year, the positive impact is there already.

Policymakers appear, in our view, ready to use these tools again as needed, or even before. Equally, monetary policy remains very easy globally, though with growth and inflation bringing the beginning of the rate hike cycle more clearly into view.

More details emerged around the tapering of Fed support during the third quarter and, while the telegraphed timeline is slightly faster than the market expected, we see it as highly unlikely that the Fed turns very hawkish or would not slow down policy changes if the environment or market changed.

This has been a key underpinning of the markets for several years and will only change in our view if policymakers feel they are losing control of inflation or see systemic asset bubbles. Rates have ticked up, particularly at the front to middle of the curve, as economic normalization continues to be priced in and supply chain driven inflation poses more of a risk to near-term policy. Notably, longer rates continue to be very well-behaved and showing no panic about sustained higher inflation.

SOLID GLOBAL CREDIT OPPORTUNITY

The backdrop described above remains favorable for corporate and traded credit in our view, though we believe selectivity remains critical (as it has all year) to navigating this environment. Overall, we still see a solid global opportunity set, particularly in the more heavily disrupted sectors where spreads have widened in recent months offering even better absolute and relative value.

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Furthermore, modestly increasing dispersion among opportunity sets in this space provides the chance to rotate capital from performing sectors into those that are lagging behind.

For example, European financials have done well this year whereas there is still good value to be had, in our view, in credits of larger, well-capitalized businesses in the cruise lines and air travel sectors which haven't tightened in line with broader markets despite positive reopening progress and a pandemic outlook that continues to trend in the right direction.

We also observe strong risk-return opportunities in structured products and real estate-related assets in the U.S., and more persistent dislocation in parts of Asia Pacific markets.

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While traded markets have experienced ups and downs, private market trends have continued apace in themes generally consistent with those discussed earlier this year.

The U.S. housing market has been very strong with significant price increases observed across the country, but we still see a wide range of opportunity in a variety of profiles given the overarching supply limitations that have been a key contributor to home price appreciation in 2021.

Covid-related travel disruptions continue to impact the hotel industry – while equity valuations have been quicker to recover, credit and special situations have been slower to react with spreads generally remaining wide. Demand for private credit across Asia Pacific continues to grow as the global economy heals.

Finally, the consumer strength noted herein is translating, in our view, to some interesting situations to participate across the capital structure of specialty finance and fintech companies.

Across this diverse set of themes, we continue to 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.

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About the Authors

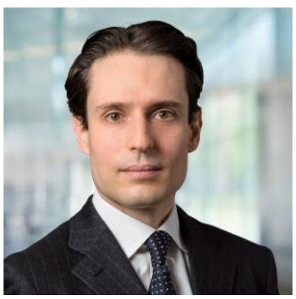
Ilfryn Carstairs
Partner, Co-Chief Executive Officer and Co-Chief Investment Officer

Ilfryn Carstairs is a Partner, Co-Chief Executive Officer and Co-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 role as 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.

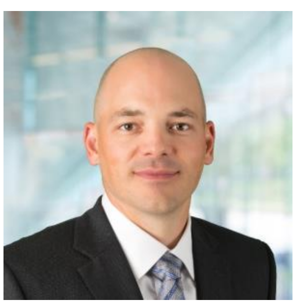


Giuseppe Naglieri
Partner and Co-Chief Investment Officer

Giuseppe Naglieri is a Partner and Co-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 London, 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 Co-Chief Investment Officer

Brad Bauer is a Partner and Co-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 $85 billion since inception and manages more than $14 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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