VÄRDE

# Värde Views: Credit Market Update

Evolving investment landscape in 2022

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## INTRODUCTION

With heightened volatility and increased dispersion across markets, 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 in 2022.

*Please note that these views were authored at the end of Q4 2021 as part of our quarterly communication with investors and may have evolved since their publication.*

The final quarter of 2021 proved to be one of the more turbulent periods of the year in terms of price action, news flow, and shifting risks to the backdrop. While most major markets posted gains for the quarter, volatility was higher and dispersion across the market increased.

We saw a more marked increase in risks accompanied by a deepening opportunity set, at least in certain key pockets. The trends and the four themes we detailed in our previous Värde Views continued to be the main drivers of the market in the fourth quarter:

**1. The Covid situation:** The widespread emergence of the Omicron variant and rapid spike in global Covid cases sustained the pandemic as the most talked about event of the quarter.

**2. Rates and Inflation**: Inflation readings are more elevated, with a clear shift in the political and Fed rhetoric around the associated risks and likely speed of policy taper and rate hikes.

**3. U.S. Politics:** Key elements of President Biden's proposed legislation failed to pass through his own party, and we tick ever closer towards a potentially volatile set of mid-term elections in 2022.

**4. China:** Woes around the property development sector continue to deepen, with policymakers seemingly unwilling to stand in the way, alongside heightened general regulatory intervention in Chinese tech companies.

The risks to the short-term growth picture from health policy and behavioral change driven by Omicron may be somewhat heightened, but the central linchpin of the virus recovery – vaccine efficacy – appears to be largely intact by reducing the likelihood of serious illness. Our chief concerns thus revolve around developments within the other three risks, and by far most notably the economic disruptions that are manifesting in persistently high inflation readings.

## MACRO ENVIRONMENT

Our concern around inflation has three dimensions to it. First and foremost, we have long held the view that inflation is the main threat to the strong monetary policy "put" that has guided market risk-taking since the global financial crisis. It now appears that the Fed has shifted its stance to be less sensitive to negative market moves associated with policy actions while inflation remains high, albeit we expect this "put" will be back when inflation moderates. Second, inflation is not only high on average, but extremely high for certain inputs. This is exacerbating industry-specific risks in several parts of the economy. Finally, while we continue to view more out-of-control, or policy-immune, inflation as less of a risk, that risk does increase the longer this inflation remains in focus as companies, consumers and workers change behavior and reinforce the impact.

The reticence around further fiscal stimulus in the U.S. is in some ways the political parallel of the shift in the Fed's view. This adds to the general setup of a market that, at least for the time being, cannot rely on the quick intervention by policymakers which has been a given throughout Covid. The developments in China are obvious in their impact, but (so far) are driving opportunity more than anything which seems to approach more systemic risk. Simply put, our view of the backdrop has moved from positive towards neutral, with a higher risk of negative tails, while valuations remain high and credit spreads tight. Neutral is not negative, and inflation with growth has plenty of balancing positives for the economy and the consumer. Corporate balance sheets remain strong while general leverage ratios and expectations of defaults are very low. However, with general market pricing where it is, this is still clearly a complex environment to navigate. Thankfully, as we often point out, averages deceive – there are several pockets of the market that are increasingly offering interesting value and lower correlation to overall market risk.

> "Simply put, **our view of the backdrop has moved from positive towards neutral**, with a higher risk of negative tails, while valuations remain high and credit spreads tight."

Looking forward in 2022, we continue to expect above average growth. It is, however, relatively easy to construct more bearish potential scenarios in the context of a stimulus that is being withdrawn from markets, perhaps faster than expected. While monetary policies around the world have yet to turn restrictive, the change in tone is clear and was particularly pronounced in the fourth quarter alongside persistently high inflation prints. On the fiscal policy side, most governments still have a bias to keep stimulus in the economy, but nowhere near the extraordinary quantum seen in the last two years. Finally, geopolitical tensions appear poised to resurface over the course of this year, with several potential sources of disruption: China, Russia / Ukraine and the U.S. mid-term elections particularly stand out. The market has been less sanguine about the backdrop with more volatile price action in the last months of 2021 and the start of 2022.

Considering all the above, we find it hard to be excited about general levels of valuations in the market as we enter 2022, and we are also wary of the potential for a poorer technical backdrop and volatility to remain high.

## CREDIT MARKETS

We expect general credit markets to (of course) be very sensitive to the outlook on inflation and monetary policy. The good news is that corporate balance sheets remain healthy thanks to deep pockets of liquidity raised in the past year. A feature of this market environment remains a record demand for credit – both for pandemic-related reasons, and as companies look to take advantage of economies reopening. High yield (HY) and leveraged loan issuances were at record levels while the corporate cash to debt ratio reached a multi-year high.

> "**A feature of this market environment remains a record demand for credit** – both for pandemic-related reasons, and as companies look to take advantage of economies reopening."

Heightened levels of corporate activity were very much associated with these levels of debt issuance. A key driver in 2021 was global M&A, which reached record levels and is expected to remain elevated over the course of 2022. The same was true for IPOs, which also hit record levels in 2021, fueled by the popularity of SPACs. In addition, several corporates are taking advantage of still low levels of interest rates to optimize their capital structure.

On the reward side of the ledger, we enter the year with credit spreads roughly unchanged from the start of 2021. Last year we expected and got an environment that was highly supportive for credit; however, we think this is less likely to be so easy or consistent in the coming year given the more complex and varied backdrop.

Despite the general calm in credit in 2021, dispersion grew throughout the year. For example, we see many credits operating in sectors directly affected by Covid that carry significantly wider spreads today than their pre-pandemic levels. We are also starting to see more pronounced signs of weakness in credits in several industries, especially those in retail-centered sectors, as a result of workforce disruption and rising input costs.

Weakness has begun to emerge in the riskier parts of credit markets as well. This is tangible in HY as we observe a general steepening of credit curves – usually a sign of investors staying closer to safety and a sign of reluctance to take duration risk. This is particularly evident in emerging markets (EM), which was one of the worst performing asset classes in 2021, both in credit and equity. These markets are suffering from various idiosyncratic events, and from the risk of tapering and tighter policy conditions. There is clearly a significant amount of distress currently unfolding in China's HY market, underscoring a long-held view of ours, that even when global markets deliver strong returns there will still be a significant credit cycle *somewhere* in the world.

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## CREDIT CYCLE

A key question on our minds as credit investors is: where are we in the credit cycle? Having come through the globally-connected cycle of Covid, we are back to a more familiar response: there is usually no single answer, and it will likely be very different for different markets. That said, the risks of a more significant turn in global credit seem much stronger to us here than they normally would so soon after a recent cycle.

As a backdrop, HY and loan default rates have fallen to their lowest since mid-2015. The confluence of extraordinary stimulus programs in response to Covid certainly suppressed the natural level of distress in credit markets. As stimulus is removed and some of the disruptions from, and caused by, Covid remain, broadly speaking we see upside in volumes from record low levels of distress. The sharp accumulation of new leverage in the past two years with a now tangible potential for higher rates, and inflation in the near-term, set up the possibility for cracks in the recent positive trajectory. Adding to this is the fact that, through the Covid period, very little restructuring or downward resizing of balance sheets occurred. Thematically the cycles that come from all this can be seen perhaps as the echo of Covid, rather than new cycles themselves, and can therefore happen more quickly.

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Many of the sub-cycles that will be important this year are already beginning to play out in different sectors and geographies. Generally, and especially for Covid-affected sectors, we believe the market is emerging from the other side of the Covid impacts, and a key question will be the resilience of issuers to changed industry frameworks and a world with less stimulus. As we look to where further significant sector stress could emerge, the supply-chain impacts on industry cost structures are a key source of risk.

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As mentioned above, China is front and center in terms of large credit markets where a cycle is clearer. The Chinese HY market, at $200 billion of USD denominated securities, is the second largest in the world and is in the midst of a significant default cycle: nearly $51 billion defaulted in 2021, $49 billion from the property sector. As a rough metric, if all issuers with a weighted average bond price below 50c go into default, we could see a 26% default rate in 2022. Although the issues are very specific to certain sectors of the Chinese economy, the aftershocks of this cycle are being felt across broader EM and related valuations.

Stepping back, it is important to frame our views on the cycle in the context of general valuations. In credit they continue to offer little room for error, especially when viewed in the historical context. For example, in early 2022, U.S. HY market spreads are around the 95th percentile over the last 10 years. Very strong, though at least roughly unchanged since the start of 2021, and less frothy in the context of the performance of other risk assets.

Could the elevated levels of equity and other valuations then be a concern? A large equity sell-off could trigger underperformance in credit too. We certainly don't claim to be equity market experts, but we look at potential froth in equity valuations as a clear risk to watch, as any technical selling in credit tends to create more volatility given the ever less liquid state of secondary credit markets.

## INVESTING LANDSCAPE FOR 2022

Looking ahead, all this creates a complex but solid backdrop for investing in global credit with heightened risks and a clear need for a strong lens on global relative value, but with the potential for deeper opportunity in certain places. Selectivity will remain key, and we see a deepening opportunity set in a number of areas.

### Public Markets: Disrupted Sectors & Emerging Markets

We see the significant stress caused by lingering effects of the pandemic bifurcating into i) companies facing diminished demand and ii) companies suffering from a combination of disrupted supply chains, labor issues (higher costs or outright shortages) and cost inflation.

The former includes a number of key opportunities which we believe still present meaningful opportunity, having experienced prolonged levels of disruption, including airlines, REITs, refining, and leisure, among others.

On the latter, we are observing higher levels of disruption beginning to hit financial performance and have capital markets impacts in numerous sectors. While Omicron, geopolitics and inflation no doubt create some noise around the recovery thesis and timing, the signals of fundamental data remain positive and clearly trending in the right direction, so for now we still expect a return to normalcy for many of these companies over the coming quarters. Nevertheless, we believe the focus should remain on large, durable businesses with strong liquidity and capital markets access; ultimately ones that are expected to survive this period of uncertainty.

Across EM, we see a mix of drivers of opportunity in sovereign debt, including the direct impacts of Covid and in some cases bad policy, which has precipitated a steep sell-off. Corporate credit markets in these regions are also experiencing significant capital gaps as the broader market appetite to finance these companies has dwindled, even among the more profitable and high-quality EM businesses.

## Private Markets: Addressing Capital Availability Gaps

Capital availability gaps remain a significant driver of opportunity in private markets. For example, the U.S. homebuilding sector continues to struggle from bank retrenchment, creating an important role for private capital in a market that remains highly fragmented and experiencing very strong demand. Land developers are still unable to produce finished lots fast enough to meet this demand against a backdrop of strong underlying fundamentals in certain metropolitan markets – with vibrant, growing economies and populations and an acute undersupply of homes – such as the Sunbelt and Mountain West regions.

We also see a deep opportunity in CRE lending, for example across hotels and certain parts of the office market where banks have tightened underwriting standards in response to the prolonged uncertainty, and where many non-bank lenders are hampered from new lending by the need to triage their back books, to varying degrees, from the impacts of the pandemic.

In addition to the $400+ billion of existing mortgages that will mature annually for the foreseeable future, we believe a Covid-induced capex cycle has been set in motion, with properties in need of repositioning to meet tenant needs. This presents the opportunity to originate short duration floating rate loans with attractive term financing secured by high quality, first mortgage collateral.

Looking globally, addressing the impact of the pandemic on both consumer and small and medium sized business (SME) balance sheets has created opportunities across the specialty finance landscape.

We anticipate levels of consumer borrowing to continue their trajectory and return to pre-pandemic levels, alongside the enduring need of SMEs to finance their bridge to recovery, re-invigorate production capacity and/or ease the challenges of disrupted and more competitive supply chains. We believe this will drive an even greater need for financing solutions, either by 'lending to the lenders', or buying and financing loans outright.

Finally, in Asia Pacific, we observe that the need for alternative sources of credit remains very high, and broad across countries and sectors. Asia is a market where we systematically see a supply shortfall for capital in providing credit solutions in more complex situations; that shortfall has been exacerbated significantly through Covid and remains at a peak.

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The strains coming from the spillover from stress in the Chinese HY market only add to this, and are driving a deep and attractive pipeline throughout the region. In India we see a lack of supply, even for healthy companies that are seeking to raise debt capital to fund continued expansion or M&A, as well as selective opportunities in what remains a large NPL opportunity in the country.

Taken together, we expect the private market opportunity set to continue to grow in 2022.

## About the Authors

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

Ilfryn Carstairs is a Partner, Chief Executive Officer and Co-Chief Investment Officer. Based in Singapore, he chairs the firm's Investment Committee and leads the firm's global business and 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 was named Co-Chief Executive Officer in 2020 before becoming Chief Executive Officer in 2022.

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. He oversees public markets investing activity and 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 oversees private markets investing activity and 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 approximately $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 has 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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