VÄRDE

Värde Views: The Covid Echo Cycle

Credit Market Update

April 2022

Värde Views: The Covid Echo Cycle

INTRODUCTION

As the delayed impact of the unprecedented policy response to Covid plays out and concerns around stagflation take hold, exacerbated by the severe economic consequences of the war in Ukraine, Värde Partners' CIOs Ilfryn Carstairs, Giuseppe Naglieri and Brad Bauer reflect on the emerging possibility of a rapid "Echo Cycle" and its implications for the credit opportunity set.

Please note that these views were authored at the end of Q1 2022 as part of our quarterly communication with investors and may have evolved since their publication.

The beginning of 2022 will long be remembered for the seismic shift in the geopolitical landscape triggered by Russia's unconscionable invasion of Ukraine.

Even before the events of this quarter, we were cautious about the environment coming into the year, with the view of an increasing risk of a rapid "Echo Cycle" as the market digests the after-effects of the aggressive policy response to Covid and its impacts on inflation and other risks to the economy.

> "Many substantial cycles through time have had their origins in the actions taken to fight their predecessor cycles, but **rarely do we see those risks transpire as quickly as we are seeing today**."

Many substantial cycles through time have had their origins in the actions taken to fight their predecessor cycles, but rarely do we see those risks transpire as quickly as we are seeing today. Covid was not a normal cycle – it was a massive economic event but what followed was a very short and shallow cycle. Reshaping that curve took "whatever it takes" stimulus from governments and central banks.

The intended and unintended consequences of that – the echo risks – were limited restructuring, historic debt issuance and leverage in the system, aggressive risk-taking behavior in both markets and the real economy, inflation, and pressure on global supply chains and input costs, to name a few.

Arriving in 2022 we were already navigating a complicated path through all of this; a path that set up for difficult conditions in several parts of the market, and which provided few general degrees of freedom for policymakers. Central to this conclusion: central banks had very little flexibility in the face of the worsening inflation picture.

The war in Ukraine has potentially shifted this picture negatively by an order of magnitude, adding to, and reinforcing in some ways, what is already a complicated set of risks. Taken together, the backdrop for credit has significantly worsened, creating in our view the conditions for a near-term turn in the credit cycle with the potential for a substantial expansion of the investible opportunity set.

> "Taken together, the backdrop for credit has significantly worsened, creating in our view **the conditions for a near-term turn in the credit cycle**."

HEIGHTENED RISK ENVIRONMENT

As we look forward, there are growing risks, some very negative tails, and a wider range of potential outcomes:

1. The Ukraine War: The first order question of how much worse the conflict may get, including the previously unthinkable risks of the potential for nuclear conflict. The second order questions of the systemic impact of commodity market disruptions and financial and economic sanctions on Russia.

2. Broader Geopolitics: With the cards yet to be fully revealed on many key near-term questions. For example: what role China or India will play with Russia; what role other energy-producing nations may take in alleviating commodity supply issues; what level of resolve Europe will have to escalate energy sanctions if the conflict protracts. Beyond this, the longer-term geopolitical implications are also likely to be profound as global economies turn inward seeking security over supply chains and input costs.

3. Inflation: With continued off-the-scale readings around the world, now exacerbated by cost-push inflation from commodities and further signs of the behavior change that may see inflation become more endemic and therefore riskier and more difficult to fight. All of this then creating particularly acute cost pressure in various major industries and the general risk of stagflation.

4. Rates and Monetary Policy: With the related, and now clear, pivot to more hawkish monetary policy globally reflecting in sharply higher rate moves across the curve, and some time before we see whether this policy change will be effective. Those rate moves against the backdrop of a market that added record debt issuance over the past two years.

5. The Chinese Economy: With the continuing lack of tolerance for Covid cases driving new lockdowns and the potential for local and global economic disruption, as well as the continued sector-specific issues around property and tech, which, despite a change in tone, continued to worsen overall and became more systemic during the quarter.

What does this all mean for credit markets?

We believe without question there will be credit stress caused by the severe cost shocks and general inflation impacting various industries. We see that already with corporate borrowers seeking liquidity and rescue-type financing in certain situations. That stress is clear from such evidence as the enormous step-change in input costs for many European borrowers.

“**We believe without question there will be credit stress** caused by the severe cost shocks and general inflation impacting various industries.”

Beyond that, it seems to us now quite likely that these pressures collectively can drive a more material industry- or geography-led cycle in credit markets later this year, a cycle much like the one we saw in 2015-16, for example. It is too early to forecast with any precision whether that cycle might be something bigger and more systemic, though the risk is now measurable.

On the other side of the ledger, it is important to weigh the positives. There is certainly buffer in the system – strong consumers, strong corporate and bank balance sheets, and solid economies and labor markets coming into the year. This will mean that cyclical stress will take some time to build and play out.

These positives are not small, particularly in the U.S., and create the possibility that (with some luck on the risk dimensions) broader stress may be avoided. A strong shift in policy, combined with a moderation in the growth environment, could also provide a silver-lining from this period in bringing inflation expectations down more quickly.

GROWING OPPORTUNITY SET

Geopolitics, commodities, and interest rates each face concurrent shocks, and we believe this disruption may potentially drive development of a significantly larger opportunity set over the medium term. We held a cautious view entering this year and believed 2022 posed greater risk to the supportive investing environment that investors have enjoyed since the pandemic recovery began.

We are not yet firmly into the next chapter of this cycle, but this seems clearly the start of something new. Importantly, there is much we can learn about the vulnerabilities of credit markets from the bout of volatility in February through early March – driven as much by higher rates as heightened concerns around credit risk. A change in narrative may be underway, as the market digests the tragic events in Europe alongside policy- and market-driven higher rates, inflation, and other disruption.

> "We are not yet firmly into the next chapter of this cycle, but **this seems clearly the start of something new**."

As the environment evolves, it's important to remain patient and the market has offered an opportunity to reduce overall exposure and build capacity for what we expect will be a more favorable pricing environment as 2022 plays out.

Disrupted sectors

Until recently, Covid-affected sectors and those disrupted by supply chain issues had formed the largest component of the liquid opportunity set in our view. However, with the events of Q1, we now see a starkly different picture.

Geographically, while we expect supply chain disruption and cost inflation to be a driver of opportunity globally, Europe is currently most acutely impacted (thus representing the most near-term opportunity). We expect the impacts on various businesses will play out much more slowly than the market would like, therefore taking time for reality to be reflected in securities prices.

The opportunity set is diverse and expanding persistently as the market digests the implications of this significant disruption with particular focus on food producers, retail, auto manufacturing, paper and packaging, chemicals, and travel. This represents a very broad set of sectors coming up in relevance in our research pipeline. We believe that the stress in these sectors should lead to opportunities in both dislocated trading and distress and restructurings over the course of 2022.

> "**The opportunity set is diverse and expanding persistently** as the market digests the implications of this significant disruption."

Global Financials

Amid sharply higher uncertainty around the war, the market has priced significantly more risk in both the equity and credit of mid-sized financials that are known or presumed to have meaningful exposure that may be impacted. In contrast to the market view, one might infer from the sharp selloff, we believe banks are well prepared to withstand this crisis and the credit impacts will be manageable, therefore we expect credits will remain intact.

The resilience of bank balance sheets through the Covid recession, which was very deep in Europe, gives us confidence that banks are in strong financial health. In fact, we believe banks are at peak fundamental strength in the post-GFC era benefiting from a decade-plus of continued improvements in capital and reduction of non-performing assets, a trend which continued, and even accelerated, throughout the pandemic environment. Despite this, the conflict in Europe remains in early stages, though it appears likely to create volatility, which we anticipate will drive opportunity over time.

Emerging Markets

In the current market environment, emerging markets have taken the brunt of the selloff following the invasion by Russia, compounding what we observed last year. A number of country-specific situations that already stood out have become increasingly interesting in the face of greater market trepidation and wider credit spreads. This continued decline has been particularly acute in commodity importer countries, or those with dependence on foreign capital inflows.

The result of this disruption is a very large universe of stressed and distressed credit, with several multi-billion-dollar sovereign structures pricing a high probability of default. In some cases, we believe those implied default probabilities are too punitive and the combination of very low cash bond prices and double-digit yields will start to offer good value.

In our view, this indiscriminate selling has produced some attractive opportunities in the corporates sector as well, where we see some examples of businesses positively exposed to the current environment (e.g., commodity producers) that have sold off nonetheless. We expect meaningful opportunity in this space as the economic disruption plays out over time.

Structured Products

We believe there is good relative value in structured products relating to U.S. commercial real estate. Credit spreads are wide to historic levels for structures backed by high-quality property, despite the recovery in underlying performance.

In our view, the market is still dislocated for specific instruments – for example, in the divergence between the trading levels of certain CMBX tranches and the apparent values of the underlying real estate collateral. Recent data depicting strong fundamentals and continued recovery from the Covid downturn shows, to us, that these assets are resilient.

Asia Pacific

We have said before that even when markets broadly are well-behaved, there can often still be a credit cycle somewhere in the world. That aptly describes the situation in China and real estate developers remain front and center in this theme. The entire sector appears in disarray, with much of it trading at distressed levels and the balance under significant pressure as the market anticipates the next domino that may fall.

While this sector remains challenged and process-driven, with progress likely to move forward slowly in our view, the opportunity set continues to broaden as other parts of the market widen in concert. We see good relative value still in commercial real estate managers with high-quality properties in top-tier cities. Other credits of interest include out-of-the-money convertible bonds of technology companies that are pricing near-zero value for the embedded option.

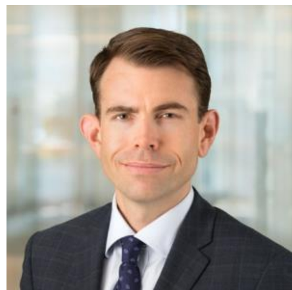
Away from China, there is still much to do in other parts of developing Asia, primarily in India, and we see signs of opportunity opening up in developed markets too. As we commented earlier, some commodity-linked credits in these markets have, paradoxically, sold off in the weeks since the war in Ukraine began, despite higher commodity prices across the board and what appears to be a more supportive environment broadly.

We will continue to share our views throughout the year as markets evolve through this complex and challenging geopolitical and economic environment.

A NOTE ABOUT UKRAINE

While we of course have a job to do interpreting the implications of war in Ukraine for our investors, first and foremost this is a humanitarian crisis. We feel very strongly about the importance of giving back and have made donations to the International Committee of the Red Cross, Doctors Without Borders and other charitable causes, in support of Ukraine, from Värde, its partners, and from many individual employees, with personal donations matched through our Värde Global Charitable Match Program.

About the Authors



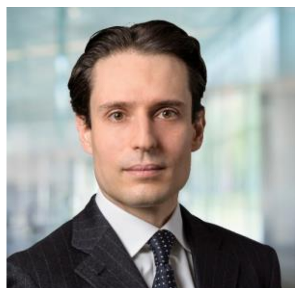
Ilfryn Carstairs
Partner, Chief Executive Officer and Co-Chief Investment Officer

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.

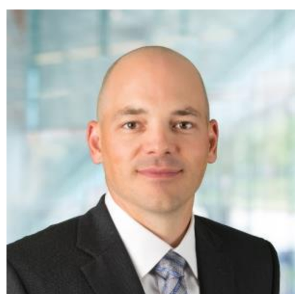


Giuseppe Naglieri
Partner and Co-Chief Investment Officer

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 $90 billion since inception and manages over $13 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.

Disclaimers

This material expresses the views of the authors as of the date indicated and such views are subject to change without notice. Värde Partners has no duty or obligation to update the information herein. The information contained in this material should not be considered a recommendation or an offer to sell, or solicitation to purchase, any security or investment. Actual events or results may differ materially from the views and forward-looking statements included in this material. Certain information contained herein is based on or derived from independent third-party sources, and Värde Partners cannot guarantee the accuracy of such information. Recipients should not rely on any information in this material. This material contains commercial information and intellectual property of Värde. This material, including the information contained herein, may not be copied, reproduced, republished or posted in whole or in part without the prior written consent of Värde Partners.

Regional Headquarters

London

2 St James's Market
London SW1Y 4AH
United Kingdom
+44 (0)20-7808-3370

Minneapolis

901 Marquette Avenue South
Suite 3300
Minneapolis, MN 55402
United States
+1 952-893-1554

New York

510 Madison Avenue
12th Floor
New York, NY 10022
United States
+1 212-321-3780

Singapore

6 Battery Road, #21-01
Singapore 049909
Singapore
+65 6579-0800