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Värde Views: The Echo is Getting Louder

Credit Market Update

July 2022

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INTRODUCTION

With a sharp acceleration in negative pressure across almost all parts of the financial markets, Värde Partners' CIOs Ilfryn Carstairs, Giuseppe Naglieri and Brad Bauer reflect on the significant likelihood of an "Echo Cycle" and what it means for the credit opportunity set.

Please note that these views were authored at the end of Q2 2022 as part of our quarterly communication with investors and may have evolved since their publication.

Driven by further significant deterioration in the backdrop for the global economy, 2022 is shaping up to be a year for the record books in terms of the depth and breadth of drawdown in markets. Stocks have recorded one of the worst starts to a year in history, while fixed income losses already far surpass the worst full year return in history.

The deteriorating backdrop has been notable and credit markets have not been spared the pain. High yield (HY) markets saw spreads close the quarter over 600bps for the first time since September 2020, while European HY spreads closed above 800bps. On these moves, U.S. and Europe HY markets were down -13.1% and -13.6% year-to-date, already the fifth-worst year on record and the worst first half since the 1970s. Primary and secondary liquidity in both markets is extremely poor, while HY CDS indices are pricing in GFC-levels of cumulative defaults over the coming years.

Many other parts of the credit market are showing equal signs of weakness and stress: securitization markets remain extremely difficult and costly to access, warehouse financing providers are pulling back and increasing rates, commercial mortgage lending rates spreads are moving substantially higher as lenders seek to pass through the increased costs of financing, and there are many large "hung" deals where underwriters are accepting increasingly large discounts to move the risk.

In the Credit Market Update we published in April, we set out how we saw 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. We see it as very clear now that we are at the beginning of a material turn in the global credit cycle. The question to us has shifted from whether there will be one, to how bad the cycle will be.

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It is easy to see how this could be an extended and more difficult cycle – certainly it is unlikely to be the short, sharp cycle experienced during Covid given the significant constraints on support from both monetary and fiscal policy at the moment. There is now clear evidence that the cure for the economic woes of Covid – overstimulating the world – has created a much bigger problem to deal with. In terms of silver lining, we have also now seen a major move in credit pricing and believe parts of the market are becoming very cheap, creating what we believe will be a huge opportunity set even against this difficult outlook.

DETERIORATING RISK ENVIRONMENT

Inflation & Rates

Chief amongst the drivers of deterioration has been the inflation picture and its impact on monetary policy. Inflation readings in both the U.S. and Europe have driven a further hawkish shift in central bank rhetoric, deepening the selloff and volatility in bond markets. Rates have moved incredibly sharply, reflecting expectations of an aggressive hiking cycle in both markets – one that is underway in the U.S. but yet to start in Europe.

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While the move in rates has been historic, at least in the context of the past couple of decades, the rates market is pricing in a sobering, albeit optimistic, path.

The yield curve indicates that central banks are expected to rapidly raise rates to around 3% in the U.S. and 1.5% in Europe, thereby slowing inflation and then being able to "declare victory" and cut rates again. For example, the market is pricing a further 190bps of hikes by the Fed over the next year, but then 60bps of cuts over the following year.

On the sobering side, broader markets are clearly wrestling with the likelihood that demand destruction comes from a hard-landing recession. On the optimistic side, the overall picture is certainly not pricing the worst case of stagflation, or inflation that central banks cannot tame.

We don't disagree the path above is quite possible, however, it is very early in interpreting where inflation is heading and many of the events of 2022 have increased the risk of it remaining elevated and driving behavior that ingrains it, including out of necessity such as the wage growth to offset the hit to household disposable income.

War in Ukraine

The tragedy in Ukraine continues with little cause for optimism or conclusion any time soon, and with the attendant severe impacts on food and energy costs and security of supply. These impacts look set to worsen as Russia restricts the ability for Ukrainian wheat to access the market and appears likely to reduce gas supply to Europe as a means of exerting influence into the winter. Both factors are driving a major spike in costs for both consumers and corporates, not just in Europe but around the world, with particularly acute impacts on lower-income demographics and poorer nations.

The Chinese Economy

China has somewhat moderated its Covid-zero policy, but this remains the centerpiece of the country's fight against the virus, creating a major overhang in its economy and further impacting global supply chains. The broader geopolitical picture remains fragile and with the risk that this period of instability leads to further conflicts, with the most fraught debate around the intentions of China with regard to Russia and Taiwan.

Shifting Economic Outlook

Unsurprisingly, all of these factors are now showing up in the economy, with many indicators suggesting a significant shift in outlook. Consumer confidence has turned very sharply, global manufacturing output is contracting, new orders are falling and inventory is rising, housing markets are slowing after a red-hot run and consumer spending, which accounts for more than two thirds of U.S. GDP, is showing the first signs of weakness. The strong economic picture coming into this year is providing a buffer to work through, but there is now no shortage of negatives trying to undo that.

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CREDIT OUTLOOK & APPROACH

The credit market enters this period very susceptible to such a sharp change in the backdrop. Debt markets have grown substantially over time, and exponentially recently. Default rates have been historically low and artificially suppressed. Rates and spreads are both moving from a very low base, making this not just a large absolute move in the cost of credit, but creating a real multiplier in this cost. Wealth effects have created many pockets of froth and excess which are rapidly unwinding.

Most importantly, it is a long time since we have entered a period of such economic and financial uncertainty without the 'policymaker put' in place. In fact, given the embarrassment associated with presiding over a loss in control over inflation, there is a good chance that there is reticence around quickly reintroducing unconventional policy even if the fight against inflation appears to be going the right way.

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Cycles, big and small, take time to develop and it is always hard to be certain about their ultimate severity early on. As ever, this is true this time. Corporate balance sheets and liquidity have been strong and there has been plenty of liquidity generally in the market. Tightened financial conditions take some time to roll over through borrowing costs.

Against this unpredictability we think there is also a certain predictability to a cycle and a playbook that operates as a good guide to navigate the market without needing to be precisely right on the ultimate path.

In short, our mantra at the beginning of the cycle is to look for places where distress is in the "seller" of credit such that good quality / performing credit is selling at an attractive discount, or credit is dislocated from related markets affording capital structure arbitrage.

In private markets we look to provide liquidity in places where there are severe capital gaps that allow us to lend to good companies or assets at attractive rates. Pleasingly we are now finding many places that are beginning to fit the bill of attractive opportunities for this point of the cycle, a major shift even across the last month.

In liquid credit we are facing an opportunity set that, just two years after Covid, is again systemic in nature. Different from the Covid dislocation, we do not expect a V-shaped recovery. At this stage investing should focus on high-quality, low-LTV, dislocated credits trading at double digit yields – a classic first stage opportunity in what we expect will be a long cycle with multiple phases of investing opportunity.

We see actionable opportunity in the large number of HY and IG credits trading at significant discounts to par with elevated current yields; we focus on those we believe offer strong downside protection underpinning attractive all-in potential returns. Meanwhile, capital gaps continue to grow across private credit, creating significant opportunity across a number of themes.

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OPPORTUNITY SET & THEMES

From a thematic perspective, the major drivers of the opportunity are the potential sharp deterioration in the health of the consumer and various significant shocks to both the operating conditions and financing access for corporate borrowers.

This is manifesting across a large variety of companies and sectors, spanning across the globe.

Disrupted Sectors

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Many companies were already managing against diminished demand on the path to recovering pre-Covid revenue and profitability levels. Now the market reflects that they may be faced with another demand shock as sticky inflation and rising interest rates impact consumption and slow growth. This latter development brings the potential for even greater market impact.

The market is forward-looking but short-term – it has already cut valuations in anticipation of declining earnings in the coming quarters. However, we believe this reaction is overdone (though important to remain highly selective and monitor for signs of risk to this thesis).

To us, it seems the market underappreciates the fundamental strength of businesses that have generated significant cashflows and raised significant capital over the past year. As a result, we believe the opportunity is here and now: we see a number of credits we favor at current levels. The travel and leisure sectors are front and center, with valuations impacted by lingering concerns of Covid and the market now facing fears of recession and declining consumer spending in the U.S. and Europe.

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Companies impacted more directly by supply chain disruption, labor shortage and cost inflation are seeing constrained revenues and dragging profitability; and therefore, declining valuations in response. We are starting to see credit pricing at attractive levels, however, we believe there may be further declines to come and are analyzing the space deliberately. We expect the fundamental damage of the current backdrop will take time to play out as many companies built up solid liquidity buffers and pushed out maturities when refinancing was easier to achieve.

While the actionable opportunities in this part of the market are slower to develop, we do believe it will be highly attractive in the quarters ahead, so we are focused on building our pipeline and preparing for the opportunities to come. Much of our focus today is on sectors such as retail, food suppliers, industrials and manufacturing, among others.

Global Financials

With the sharp sell-off in financials credit in Q2, we saw the opportunity set expand notably. Though trading in the sector remains orderly, the selling pressure has created opportunity and we find attractive value even in higher-quality credits. Initially, as the early shock of the Russia/Ukraine war tempered, sentiment improved around the credit quality of European banks. However, that sentiment swiftly reversed course as the market adjusted to the worsening backdrop and trading levels today indicate a fear these conditions will persist for much longer.

Against this, we see a financial system with many players that are relatively well-positioned to navigate a downturn, better capitalized than they have been in years, with an opportunity to expand interest margin amid rising rates and upgraded portfolio credit quality with decade-low ratios of non-performing assets.

Separately, demand for private credit continues to increase across specialty finance companies as borrowers face a more fragile public credit market and varying degrees of access to the securitization markets with a growing number of borrowers looking to raise defensive capital to navigate a protracted period of market dislocation.

Emerging Markets

EM economies faced enormous challenges in recent quarters and the damage continued unabated in Q2. This quarter brought a new wave of stressed and distressed issuers, new defaults and significant volatility as trading markets oriented to these developments.

As in other markets we follow, worries about inflation and the impact of developed markets' rising rates have roiled EM economies and traded markets. Talk of food supply shortages is a sobering possibility underscoring the human risk to all this. Energy importing nations may face the most difficult environment of all, beset by shocks to multiple critical economic inputs at once.

Valuations are back to depressed levels and we are evaluating the landscape cautiously. It may be possible to identify situations where credits have been oversold and can recover, or where external lenders may provide relief and a path to sustainable recovery, but for now there is much uncertainty and better relative value is on offer in other markets in our view.

Real Estate & Structured Products

A range of real estate-related sectors and structured products came under significant selling pressure in Q2, as investors faced the dual risks of rising rates and signs of a slowdown in economic activity. In our view, the market selloff has moved ahead of the likely decline in fundamentals the current downturn might impose.

The U.S. housing market has seen companies at all levels of the value chain be disrupted by sharply rising interest rates and mortgage rates. We believe the recent slowdown was healthy, perhaps even necessary, considering the competition for homes and escalating prices caused by excess demand and bottlenecks in supply. Our research shows that the housing market is moving towards an equilibrium rather than falling off a cliff and, therefore, believe there may be value in parts of the market where fundamentals remain intact. The market appears to be pricing in a structural decline but we anticipate a much milder cyclical slowdown than we saw in 2008-2009. At present, we see potential opportunities among mortgage originators, homebuilders, and building products manufacturers and suppliers.

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Unlike residential real estate markets, commercial real estate (CRE) faces the additional headwind of entering today's environment with generally low cap rates in a rising rate environment. We remain focused on defensive sectors within CRE that we believe offer rental growth to offset cap rate expansion.

We are also seeing opportunity in single asset single borrower (SASB) CMBS in structures backed by large, high-quality properties and trophy assets located in prime travel and tourism destinations.

Energy

It has been a year of strong fundamental conditions for energy production and services companies, with persistently higher prices for energy commodities and constrained supply around the world. Despite this, credit spreads in the space only partially reflect that reality in our view. In fact, many credits in our research universe sold off over the quarter as concerns over the future path of the economy took further hold. We see a number of credits in the space that now trade at attractive levels given the strong fundamentals and cheaper valuations.

Asia Pacific

Significant distress in China remains the headline of the opportunity set in Asia Pacific traded credit. Though not all of the opportunities in the region are directly linked to the property developer distress or tech sector volatility, those markets provide the clearest read on sentiment. A few narrow sectors are of interest: tech sector convertibles; China commercial property manager bonds; and commodity producer corporates in several countries. We believe there are some opportunities in long credit and spreads trades in distressed China property developers but are wary that the restructuring process is still uncertain and any resolution will take time.

The most notable impact of the change in general credit conditions in Asia remains the demand for private capital solutions from corporate borrowers throughout the region. In this area of our business, we see a very deep pipeline, and one where risk / reward has moved substantially, even from where it was in the first quarter of this year.

CONCLUSION

The investing environment now has dramatically improved from where it was at the start of the year. As global markets strive to digest the deluge of new information and a deteriorating backdrop, we have seen significant volatility in headline indices and more of it beneath the surface of the credit market – this volatility has delivered very strong breadth to the opportunity set and a substantial new volume of credits to our research pipeline.

Our conviction in the developing opportunity set has grown significantly this quarter, and we feel very well-positioned to navigate the ups and downs of what appears to us to be the beginnings of a major turn in the credit market globally. With nearly three decades as a firm operating in the credit markets, we've successfully navigated many prior cycles and have a strong playbook for navigating these periods of time, which will again guide our approach to both opportunity and risk over what promises to be a dynamic time in the market.

About the Authors

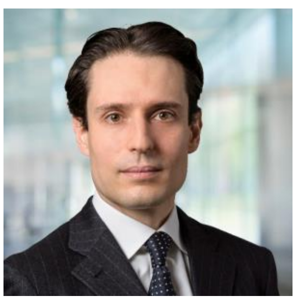
Ilfryn Carstairs
Partner, Chief Executive Officer and Co-Chief Investment Officer

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.

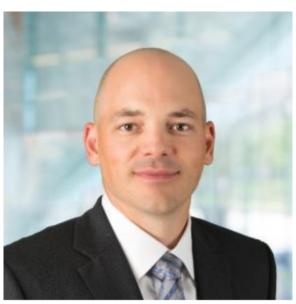


Giuseppe Naglieri
Partner and Co-Chief Investment Officer

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.

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