Värde Views: 2024 Market Outlook and Opportunities

Credit Market Update

February 2024

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INTRODUCTION

Värde Co-CIOs Ilfryn Carstairs, Brad Bauer, and Giuseppe Naglieri discuss the outlook and opportunities for credit investing in 2024, examining the forces shaping the economic landscape, areas of potential volatility, and the trajectory of the credit cycle.

Please note that these views were authored at the end of Q4 2023 as part of our quarterly communication with investors and may have evolved since their publication.

MARKET OUTLOOK

2023 was a year that saw several shifts in the market narrative, many of which were quite volatile, as the investing world tried to interpret the implications of what has certainly been a very unusual few years for the economy and markets.

While the market enters 2024 pricing low volatility and generally calm seas, we expect this year to again be volatile with much uncertainty to resolve before it is clear what path the economy is on, and then the implications for different parts of the market. We aren't particularly bearish on the immediate fundamentals and continue to see a long distance to any very hard landing scenario for the U.S. economy, though it seems to us that this view is well and truly in the price of more liquid markets.

Fundamentally there are plenty of risks to monitor, but few are flashing red now, and the degree of economic resilience thus far is unlikely to be overcome quickly without some major red flashes. All-in-all we aren't nearly as sanguine as the soft or no landing consensus crowds, but we can see a balanced view for 2024, including a risk that the economy runs too hot again in the near term, which would presumably take rate cuts off the table.

We have had a clear model over the past year for thinking through the opportunities and risks in credit this cycle, and we think it continues to hold very well as we look at 2024.

CHARTING THE CREDIT CYCLE

Excerpt from July 2023 Värde Views: "Behind the first door ("Door A"), higher for longer rates and tight policy create a math problem even for reasonably solid credit that cannot pass through the step-change higher cost of borrowing. Behind the second door ("Door B"), weaker earnings, but potentially looser policy and somewhat lower rates, reduce some of the math problems but increase the earnings-related stress. Clearly there are a range of paths once a door is open, but behind either door one would want to be highly respectful of downside protection and accurately assessing the ability for specific borrowers or assets to navigate what the cycle may throw at them."

The economy is firmly now several quarters into a credit cycle and, in our model, seems clearly behind "Door A" as we have described it: a cycle squarely impacting the most financing dependent parts of the credit universe. From here we expect higher-for-longer rates to continue to expand the opportunity through both credit and capital availability stress.

This is already a major credit cycle. Given the magnitude of the markets involved, it has been surprising how little spillover there has been. It is a cycle that is behaving differently to those we saw prior to Covid. That said, we believe credit markets are much weaker than meets the eye, particularly in terms of availability.

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The economy is behind Door A until it isn't. From here, a few paths could emerge:

- The cycle plays out through the passage of time, running through 2025 and bringing continued expansion of the existing opportunity;
- The cycle morphs to something different – a "Door B" scenario with a meaningful recession, bigger and likely different opportunity set, and lower rates; or
- The cycle heals quickly, leading to much lower rates without a meaningful economic correction and with strong returns but less forward opportunity.

Our base case for the year is that the economy stays behind Door A. There are several ways it could shift to Door B. There are very few plausible ones that would see it heal quickly enough to escape Door A, in our view.

Where to in 2024? It's naturally tempting to just push out a recession forecast by some number of months, one will eventually come and they always operate with some lag, but it's more important to articulate and track those factors that could quickly overcome the resilience we have seen. In this vein, it's easy to produce a watch list but less easy to point to any collection of observations on that list that rise fully to the level of recession warning just yet – save perhaps for the inversion of the yield curve.

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CREDIT MARKETS

A credit cycle is in full swing in financing-dependent areas of the market, such as CRE, leading to a significant pickup in delinquencies, much wider spreads, and anemic new issuance; all of this in both public and private markets. We are well within a multi-year period in which the availability of credit will be lower and the all-in cost significantly higher than pre-2022. We continue to hold this view despite the benign evolution of the macro backdrop over the course of 2023, especially relative to general expectations.

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These environments are typically accompanied by very strong issuance, especially considering the record low level of issuance in 2022 and the steep maturity wall in both HY and leveraged loans globally. In fact, issuance remained subdued in 2023 with U.S. HY gross issuance more than 40% below the 10-year average. A few specific factors drove this, mostly driven by the crisis in U.S. regional banks and the lack of a clear central bank pivot for most of the year.

Nevertheless, such low level of issuance is a clear sign that credit availability is still limited, with significant implications for opportunity and potential defaults. As a result, the wall of debt maturities has not been dented very much at all, which will remain a key driver for credit investing over the course of 2024 and beyond.

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Selloffs in corporate and other credit markets have been relatively short lived when they have come. Average spreads have not stayed elevated for long and are not just well inside historical averages as we enter 2024, but closer to the post-GFC tights.

This lack of contagion is different from prior cycles. The most obvious explanations? Default activity has been very isolated and borne by different investor bases. High yield investors have seen some uptick in defaults but not yet to meaningful levels. Most stress has been in private credit markets – bank- and private fund-held – or in structured products. This has likely limited panic selling. Further, with the economy more resilient than usual this cycle, there have been many winners too – companies that can pass through inflation and maintain growth.

Even with corporate credit spreads at tight levels and general risk markets in good shape, the corporate credit market is less healthy than it may seem. In primary markets, HY issuance remains significantly below the average of the previous five years, and there was more issuance in the first half of 2023 than the second. This is despite the recovery in markets over the year and the panic around regional banks in March. We don't lean on this as a major point, but it certainly reflects in the price that any even slightly non-conforming credit must pay up to access capital, at a cost materially higher than the averages suggest.

OPPORTUNITY SET

The opportunity set remains massive and has grown further in some very large and important places – real estate stress, bank capital needs, Asia private credit, and single name credit stress.

Capital availability for more complex credits and the cost of that capital continue to be factors driving the opportunities. Simplistically, we expect three major forces to drive most of our investing activity in 2024:

- New credit has been very scarce in a way we have rarely seen, making it a great time to be a lender.
- Stress is building in several places, making it a great time to be a solution provider or fundamental credit selector.
- The system needs capital and wants to de-risk, making it a great time to provide structured capital solutions or buy assets off banks.

With the rally in liquid markets, the tilt of the 2024 opportunity has shifted further towards private credit solutions, though, as we have noted earlier, we anticipate bouts of volatility and thus opportunity as the year progresses. This shift leads us to apply a private credit approach to create transactions in the traded credit markets, such as new money solutions, club new issuance, and private securitizations.

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As we survey markets and the economic environment heading into a new year, there are several themes we are capitalizing on today and those we expect will become much more relevant as the year develops. We describe these specific themes in further detail below.

PRIVATE MARKETS

Commercial Real Estate: The commercial real estate sector remains the epicenter of this cycle with elements of macro stress influenced by rates, large capital gaps, and pockets of fundamental stress. There are many ways to think about investing against this backdrop. Some opportunities are more obviously attractive and actionable in the nearer term while other sectors are in the early stages of what we expect to be an elevated cycle of legitimate distress.

CRE credit is a nearly $5 trillion market in the U.S. alone and is on a path for a massive stress and default cycle. That stress will not pass quickly in our view and will grow through 2024 and 2025. The approaches that we expect to find most compelling in the coming year include:

- Senior, bridge lending secured by well-located collateral in healthier sectors and markets buoyed by tightened lending standards;
- Refinancing or extension facilitation through capital solutions in the form of higher LTV, unitranche loans or mezzanine capital where equity value has eroded, and where existing leverage exceeds what is available from traditional senior lenders;
- Purchasing performing loans or portfolios from banks and other participants looking to de-risk or release regulatory capital; and
- Purchasing loans or assets in more stressed or distressed situations with a clearer need for restructuring of junior debt or repositioning assets to improve performance.

We have a number of high conviction themes in CRE, albeit all viewed with some degree of caution given the overarching reality that capital in the sector will, justifiably, be selective in the coming years.

In **multifamily**, we remain of a positive medium-term view on housing fundamentals in general but selectively cautious on rents from an affordability perspective. Furthermore, valuations will remain in a state of flux in the current backdrop and warrant a greater margin of safety, such as credits with meaningful equity cushions behind them.

We are constructive on the **hospitality** sector and focused on better quality assets without material dependence on a significant change in the shape of business travel.

Finally, we still have not seen many instances in **office** where we can build any real conviction. Ultimately, the likelihood of "baby out with the bathwater" scenarios arising will be reasonably high given the limited interest from investors in the space. The asset profile with some potential will be those with higher quality credit tenants with significant lease term in newer assets.

Housing: While CRE is undergoing a substantial degree of stress, U.S. housing markets are much more balanced and at a macro-level remain generally undersupplied. Despite the more recent challenges to affordability with home price appreciation, higher mortgage rates, and elevated rents, homebuilding margins remain robust, new home sales continue, and well-located lot supply is in high demand.

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Fundamentals vary vastly by market; we have become gradually more constructive on select markets with a particular focus on financing **homebuilder lot inventory** for construction of single family, for sale homes.

Away from single family, we also maintain a very positive view on **student housing** in urban centers. We are particularly focused on New York City where we continue to see potential for conversion of urban hotels to student housing facilities.

Dedicated student housing units in that market fall vastly short of meeting student demand for reasonably located, affordable, and suitable housing options.

Asset-Based Credit: The asset-backed and specialty finance credit market experienced a more pronounced shift in opportunity over the latter part of 2023 and heading into 2024. We saw several transactions in 2023 that were bilaterally structured, private securitizations of performing collateral for regular structured product issuers during a period where ABS markets were effectively shut to issuance. These privately structured transactions evidenced how deeply broken ABS markets were last year, though they certainly saw some liquidity return in the later stages of 2023.

Larger club and syndicated ABS and corporate private credit saw more material spread tightening at the end of the year, as the weight of dry powder in that space met the inevitable pressure to go to work. Mid-sized issuers and transactions, however, remain less competitive. Credit origination transactions, across both **commercial credit and secured consumer collateral**, in the $50-200 million range tend not to attract the attention of the mega-cap private credit players and have therefore held up much better in terms of both pricing and terms.

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Finally, the purchase of **whole loan portfolios** remains a key theme for us which we expect to grow further as banks and other credit platforms look to raise liquidity and de-risk around the concerns of ongoing consumer stress.

Another theme in focus centers on the broader bank de-risking and regulatory capital stress, which we expect will remain front and center for the bulk of 2024. The substantial opportunity in **significant risk transfer (SRT)** transactions in 2023 is continuing into 2024, particularly in the U.S. as regulatory pressure continues to ratchet higher off the back of the regional banking crisis, and regulators have provided increased clarity as to the SRT structuring solutions they will accept to grant capital relief.

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Asia Pacific Private Credit: From early 2022 through the middle of 2023, borrowers in Asia had not fully come to terms with the higher global price of risk. As relative value has rebalanced and jurisdictional return premia reestablished over the latter part of 2023, the number of opportunities across India, Australia and Indonesia has grown substantially. While credit supply in the region is still cautious, the need for capital is strong and growing and we are seeing significant demand for access to credit, especially in sizes that are globally relevant. Similarly, we see deal terms that we view as highly attractive in both a local and global context.

TRADED MARKETS

Global Financials: Bank credit benefitted from an outsized rally over Q4 as the market more fully priced in the strong earnings and sound capital position many banks demonstrated throughout the year. Our positioning last year, mainly in national champions and the next tier of top banks in Southern Europe, was advantageous as the sector compressed and wider spread credits gained ground. The sector still appears to be cheap relative to fair value as the risks of higher-for-longer rates and slowing growth or recession hang over the market. As such, there are still some good opportunities in the market.

Additionally, we are focused on a pipeline of credits that haven't fully kept up with the sector and which offer, in our view, compelling relative value against the broader opportunity set, given: high current yields, call dates / paths to refinancing to potentially accelerate returns, and still strong downside protection from solid fundamentals that we believe should remain intact even if a slowdown turns to recession in ordinary course.

The U.S. banking sector on the other hand has been remarkably calm as the implosion of several regional banks in Q1 2023 is now a distant memory. The rest of the sector has generally performed quite well through the back half of the year and the risks stemming from stress in bank CRE portfolios hasn't yet manifested. However, we believe a deleveraging of CRE is still in its early innings, and it may be the case that a CRE-led impact to the banking sector just hasn't reached its peak yet – as opposed to having largely come and gone by now. Patience and careful selection will be the best path to value and returns from here.

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Dislocated First Lien: An investing theme reliant on dispersion and single-name credit events continues to be a rich source of opportunity heading into 2024. While Q4 2023 was characterized by a strong rally across markets and most sectors, dispersion remains in pockets of the market. We saw certain credits punished with aggressive downside for earnings misses, idiosyncratic disappointments, or both, and the market remains highly cautious towards certain more recession-sensitive industries, yet highly optimistic about the most in-favor sectors – optimism which seems now fully priced in.

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To us, this presents opportunity. In market environments featuring that broad range of market sentiment, we believe it's more likely that good values and stronger margin of safety in credit can be found through diligent selection. Our emphasis remains on finding that value in first lien bonds and loans of mid-size businesses entering into a recovery or inflection in fundamental performance – or, similarly, the outperformers in unloved sectors.

Increasingly, we expect to seek out these opportunities in more recession-sensitive sectors, where stress is already picking up and the toll of higher interest costs may force companies to reckon with leverage issues sooner rather than later. Industrials and consumer discretionary, for example, appear likely to feel the bite of any slowdown sooner than elsewhere. There are a number of companies with good businesses but burdened by too much debt that will need to de-lever.

Real Estate & Structured Products: While the real estate cycle continues to develop slowly, the sector remains, in our view, most likely to drive the next leg of volatility and negative economic impact. Rate levels lowering over Q4 2023 certainly help moderate the challenges, but we still see risks in highly levered situations or overly optimistic income projections that underpin unsustainable business models in the current climate.

Europe appears poised to see a CRE-led downturn first, and cracks are already showing even among some of the largest real estate businesses in those markets. We are starting to see more interesting opportunities in bonds of real estate companies or secured debt backed by the assets directly. Even performing credits are trading wider and seemingly cheap to fair value, while distressed situations have fallen dramatically. We expect 2024 will bring more meaningful opportunity to position for recovery or restructurings as more of these untenable capital structures search for liquidity or maturity solutions.

CONCLUSION

We see another dynamic year ahead and one that will be very busy on the new investing front. The demand for capital, and credit in particular, appears unlikely to temper soon, even at today's elevated cost of capital. It could even accelerate if that diminishes with the help of accommodative central bankers.

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In this type of environment, an opportunity set is rarely comprised of only one or two actionable themes, and across a year, particularly a volatile one, some of those themes go up and down in importance.

The strength of our platform has been a highly valuable asset in navigating these shifts, giving us the ability to flex to the places where we view value as most compelling. Importantly, the quality of the opportunity continues to allow for deal flow that doesn't force us to take downside risk on getting that bet exactly right.

All together, we believe it will be another active year in our business and a strong opportunity set for credit investing that seems set to persist through 2024.

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 co-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-CIO in 2017 along with his move to Singapore. He was named Co-CEO 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.

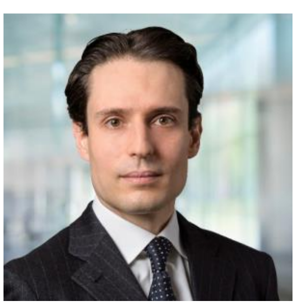
Brad Bauer
Partner, Co-Chief Executive Officer and Co-Chief Investment Officer

Brad Bauer is a Partner, Co-Chief Executive Officer and Co-Chief Investment Officer. Based in New York, he co-chairs the firm's Investment Committee and leads the firm's global business and investment strategy.

Brad joined the firm in 2007 and was named Partner in 2013. He has held a variety of both business and investing leadership roles working out of the firm's U.S. and U.K. offices. From beginning his career at Värde on the Corporate and Traded Credit team to later leading the firm's private credit strategies, Brad's extensive investing experience spans numerous industries in public and private markets. Brad has served in a CIO role since 2019 and was named Co-CEO in 2023.

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.



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.

About Värde Partners

Värde Partners is a leading global alternative investment firm specializing in credit and credit-related assets. Founded in 1993, the firm has invested more than $100 billion across the credit quality and liquidity spectrum in both public and private markets. Värde currently manages approximately $13 billion in assets with teams in North America, Europe, and Asia Pacific focused on Corporate & Traded Credit, Real Estate, and Financial Services & Diversified Private Credit. For more information, please visit www.varde.com.

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