VÄRDE

Värde Views: The Evolving Credit Cycle and Investing Landscape

Credit Market Update

April 2023

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INTRODUCTION

Following a volatile first quarter of 2023, which saw historic bank failures and regulatory intervention, Värde Partners CIOs Ilfryn Carstairs, Giuseppe Naglieri and Brad Bauer discuss the turn in the credit cycle – now accelerating in earnest – and the investing opportunities resulting from rising stress and dislocation across traded and private markets.

Please note that these views were authored at the end of Q1 2023 as part of our quarterly communication with investors and may have evolved since their publication.

Observers of the market can be forgiven for developing a sense of fatigue around the use of the word "historic" over the past three years, as it seems we are using that word to describe events on a regular basis. Nonetheless, the first quarter of 2023 produced more history on both sides of the Atlantic, via the escalating deposit crisis in the U.S. regional banking system and the volatility in Europe's banking system centered on Credit Suisse. The former has so far led to three bank failures, including the second largest in U.S. history in Silicon Valley Bank, while the latter saw the regulatory intervention in Credit Suisse and its hastily arranged acquisition by UBS – arguably the most significant intervention of a major bank we have seen in several decades.

Coming off the beginning of the year where risk appetite was strong and volatility quite low, these events in March provided a sharp contrast and are another reminder that we are in the early stages of processing a significant turn in the credit cycle. There are many parts of the credit market offering peak-of-the-cycle type spreads driven by very large gaps in capital availability – and the number grew significantly during the first quarter. The traded market became much more interesting and dislocated, epitomized by the chaotic price action in securities of Credit Suisse itself and the echoes we have seen in the weeks since. Private market credit availability continues to be dire in several large markets. These opportunities are actionable now and provide attractive risk/reward in many places. The cycle is now on in earnest and looks set to grow as credit conditions via the banking system tighten even further.

INVESTING LANDSCAPE

The Triple Threat

We see the first quarter as highly confirmatory of the forces we expected to shape the market this year. Indeed, we have moved through the gears of these forces already incredibly quickly. Most notably:

- Inflation has remained very stubborn and shown signs of re-accelerating in Europe and the U.S., where the real economy and employment remains very strong.
- Inflation is showing signs of becoming endemic in the behavior of consumers and corporates.
- These facts very quickly exposed the Catch-22 we wrote about last quarter, which saw policy makers turn more hawkish and shift expectations away from rate cuts and towards higher policy rates in 2023.
- The financial world is very levered and fragile to these conditions, and still dealing with the lagged effects of monetary tightening last year. This will accelerate – deepening the credit cycle – whenever the market prices higher and/or longer high rates as we saw in Q1.

The lag to breakage is very fast in places, and more of a slow-moving force in others. As we wrote to begin this year, our framework to think about this is the “triple threat” of this cycle – places that exhibit: 1) rates-sensitive valuations, 2) high market dependency for financing and 3) low ability to pass through cost inflation.

Seen through this lens (with hindsight), U.S. regional banks face the triple threat acutely. Their asset books contain a lot of longer-duration fixed rate lending – highly rate sensitive and already carrying large unrealized losses. They are dependent on deposits – a daily rollover financing product. They have very limited ability to pass through higher deposit costs to their lending book with any speed. Other large spaces are also now firmly in the market’s sight for their exposure to the triple threat. CRE credit being perhaps the most notable, particularly the office space.

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Policy Dynamics at Play

The issues for policymakers from this backdrop are now fully in view. What do you pick, controlling inflation or systemic stability? Or indeed how much risk on one dimension will you take in balancing the other, especially given that they ultimately will correlate (persistent systemic stress will flow through to the economy)? Unsurprisingly perhaps, the tendency seems to be to act quickly with less consideration of future consequences. The same dynamic was at play during 2020 and 2021, leading us now to this “echo cycle.”

In 2023 so far we have: blanket deposit guarantees for the few failed banks of this episode and a faltering commitment to do more if needed (arguably this encourages more deposit flight); a new unlimited but expensive Fed collateral repo facility that lends against par rather than market values; and hasty changes to Swiss law in the Credit Suisse case, enabling both the recovery of equity ahead of debt and a forced weekend marriage of banks with no shareholder vote – hasty policy with potentially longer-lasting negative effects.

In general, policy has felt somewhat like an out-of-control chemistry experiment over the past 6 months. The rates markets provide the starkest illustration:

- Having tightened financial conditions significantly in 2022, the Fed allowed a more dovish narrative to prevail in January 2023 with the market reducing expectations for the terminal rate to 4.8% and pricing several cuts by the end of the year (one-year out rate expectations fell to 4.2%).
- As inflation data continued to show stickiness, the Fed very quickly put faster hikes and “higher for longer” back on the table. This moved terminal to 5.7% and one-year out to 5.5%.
- As the banking system shook, arguably catalyzed by the aggressive rate moves, terminal fell back to 4.7% and one-year out to 3.7%.
- As we write this in early April, terminal expectations are back to 4.9% and one-year out to 3.6%.

All of this both reflects volatility and amplifies it. Cutting through it all though we are in a very similar spot to where we started the year: a massive tension between a still strong real economy producing “unacceptable” levels of inflation and a financial economy that is historically levered and showing signs of buckling under the requisite higher-for-longer rates backdrop.

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The degrees of freedom for a "soft landing" are very low, in our view, and fell lower during the first quarter. A key lesson of the quarter is the importance of lag time in interpreting this market. How much economic damage is coming down the pipe from higher rates and wider spreads? Q1 2023 suggests this is already substantial. In the background remain other risks and forces that may impact the market – geopolitics, the looming fight over the debt ceiling in the U.S. and the overall U.S. political scene as we head into another uncertain Presidential election season, including the likely temptation for spending promises under the guise of buffering the impacts of inflation.

Reading the Market

Superficially we are also in a similar place to the beginning of this year when it comes to the contradictions priced into different markets. As noted above, the rates market suggests we are basically at the end of the hiking cycle and will get 100bps of cuts this year. The equity market meanwhile is solidly up for the year and appears to price in something of an immaculate landing, or the best of both worlds – both a strong economy and a less restrictive central bank. It remains hard to see the path to an aggressive cutting cycle this year without some shock preceding it that puts a more significant dent in general risk appetite.

We say "superficially" because there are now many more parts of the broader market that are pricing in this risk, particularly in credit. Our old watchwords: "averages deceive." Credit spreads have moved back towards the wides of last year and even these levels are something of a red herring. Dispersion is enormous. New issuance remains very low in all forms of credit, and the price paid to access the market is much higher than traded averages. The premium for credit without direct market access is even higher still. There are multiple opportunities emerging in our pipeline to plug these credit gaps, and to do so for healthy borrowers and assets.

A Converging Cycle

The issues in credit are now also significant enough to drive the tighter linking of interactions across the market that make a cycle spread, in our experience, from one segment to another. This is the essence of a credit cycle; problems, when they occur in large enough parts of the market, create more problems. Credit standards tighten, availability goes down and costs go up, drawing more sectors of the market into stress.

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Another major shoe has now dropped on this front. The pipes of credit provision were already bad coming into this year and have gotten quickly much worse. Most simply this can be viewed through the U.S. regional banking lens. A significant portion of U.S. lending in recent years has come from this channel. Regional banks are not just reducing lending now, they are going the other way, attempting to sell or pledge assets to raise liquidity as deposits flee. The sleepy equilibrium of being able to fund themselves with deposits well below the T-bill rate, and thus pass through credit at a lower cost, has been thrown into the spotlight. Credit sectors that are large and sensitive to the risk, such as CRE lending – a $4.5 trillion space in the U.S. with ~40% coming from banks of which ~80% is provided by regional banks[1] – come further into focus and other lenders pull back. This amplifies the effects and leads to self-fulfilling stress even in high quality assets and borrowers.

This process clearly informs our general approach to investing across a cycle. Early on, high returns are available simply for being a provider of capital to high quality borrowers. As the cycle matures, uncertainty reduces and capital returns for these higher quality situations, but there are numerous opportunities to invest in situations of actual stress and distress.

We are firmly in the first phase of the cycle. Cycles often take 18 to 24 months to play through and, in this phase, it's especially important to respect uncertainty

1. Source: MBA; Federal Reserve Board of Governors; Trepp LLC; BCA Research. Regional banks defined by <$250 billion of assets.

and the value of capital, swinging only for high quality returns with downside protection, and to be disciplined about taking on distress. Equally, when you see opportunity that fits the bill, invest.

Looking across our platform there are plenty of areas for patience, but several are in that sweet spot today; in aggregate it is one of the richest environments we can remember at this point of a cycle.

Outlook

The outlook for global growth and monetary policy has clearly been volatile this year and, looking ahead, there are some clear scenarios to debate:

1) The credit spillover from regional banks and the Credit Suisse situation is manageable, and economies continue their strong trajectory – in this scenario, the rates curve is very wrong and policymakers will have to go further or at least hawkishly hold rates; or

2) Credit spillover is managed and inflation continues to moderate, growth shocks are contained and the soft landing is achieved;

3) A hard landing where the lagged impact of monetary tightening is exacerbated by a tightening of credit conditions and economic spillover is severe.

The path to achieve scenario 2 is very narrow with the risk of policy error very high. Overall, we expect the coming months to continue to be characterized by high volatility.

OPPORTUNITY SET

Even with a view that the backdrop gets worse, it is a very fruitful time to invest in credit. Entering our 30th year of investing in credit, there are parts of the market presenting a strong mix of absolute return, wide spreads and downside protection that is very rare in our experience.

Against the markedly complex backdrop emerging in the first quarter, we saw strong follow-through in the opportunity sets we highlighted last quarter. Several of these opportunities became more compelling, spurred by rate hikes and the banking sector woes that evidence rising stress. Segments of the market offer now a level of quality in risk/reward that we seldom see and which generally doesn't persist for long as other buyers will quickly flock to safety in good assets if markets see another leg down as this cycle accelerates in earnest.

Below we provide a brief update on a few actionable parts of that broader opportunity set, and in particular highlight where the opportunity ahead has changed most visibly.

Traded Market Opportunities

Global Financials: As we discuss above, banks globally generated more than a fair share of headlines in Q1, punctuated by bank failures in the U.S. and the destabilization of Credit Suisse. Though this initial volatility sparked by a run on liquidity lasted only a matter of days, it's clear that significant asset quality issues – both in duration of securities portfolios and credit risk of loans (e.g., CRE) – will take longer to repair and impose a fragile state on the bank sector. Even as trading levels have largely retraced by now in early April, the damage is by no means healed and we expect this sector will continue to bring many opportunities ahead.

Dislocated First Lien: In corporates, we still find the best relative value atop the capital stack in quality mid-size businesses where we believe discounted first liens offer strong downside protection and outsized return potential. Even higher quality businesses are forced to pay up to raise capital in this market and we focus on situations offering multiple paths to a profitable outcome. Through careful credit selection, we believe there are multiple scenarios to realize double-digit yields or better: i) through re-rating or refinancing if yields tighten and/or capital markets reopen in a better market or ii) by capturing incremental economics through amendments or restructurings.

Real Estate & Structured Products: Real estate in the U.S., and globally to a lesser extent, appears set to become significantly more distressed which should create multiple workstreams of opportunity as this cycle deepens. The banking sector woes are only the initial warning signs of the triple threat impact we believe will cause significant dislocation, driven by massive capital needs and a broader valuation reset in these markets. A market broadly fueled by falling interest rates, rising valuations and increasing leverage is trapped as these forces reverse. The early stages of opportunity are already taking shape in structured products, REITs and other real estate-linked businesses such as regional banks and mortgage originators.

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Private Market Opportunities

Commercial Real Estate: As mentioned in the section above, perhaps the most in focus and well covered concern centers on the real estate sector – a levered asset class with valuation sensitivity to higher rates and wider spreads, particularly in property types that are not able to maintain rental growth in line with inflation. The last month or so has simply brought the known issues right to the front of mind given significant loan maturities in 2023 and 2024 coupled with lower valuations, higher cost of credit, and limited equity capital available to plug the gaps. We are seeing heightened opportunities with an expectation of much more to come, inclusive of:

- Senior lending to facilitate refinancings, acquisitions and restructurings;
- Gap capital in the form of mezzanine or preferred equity to bridge the void between senior lending proceeds and existing debt balances; and
- Special situations where current values break in existing senior or mezzanine debt and equity is out of the money.

Specifically, we see pressure emerging more quickly in a few areas, inclusive of newer construction multi-family with construction loans maturing, hotels that had not fully recovered from the pandemic, and office of all flavors with the outstanding questions around supply and demand. While the office opportunity remains a longer-term issue that will play out over years, the issues have accelerated in the last month in private markets as evidenced by the trading performance of office-focused REIT securities.

Specialty Finance: While less directly impacted by regional bank fallout as compared to CRE, the flow through into valuations and cost of credit for banks with a focus on specialty finance assets as well as non-bank finance companies is notable, particularly for those businesses focused on consumer credit. For non-bank lenders, capital was already very tight, ABS markets have been less welcoming, and warehouse capacity should become incrementally more challenging as larger commercial banks, which were already somewhat tight on capital in 2022, attempt to absorb the impact of regional bank fallout.

Fund Financing: The market for fund finance has grown substantially over the last few years with the growth of alternative asset management. The products most widely utilized generally receive punitive regulatory capital treatment. Notably, several regional banks, including Silicon Valley Bank, Signature Bank, and First Republic, have also been large players in that market. So, at a time of already growing demand for this type of credit, the demand is pushed to a smaller subset of banks with limited capacity available. Consequently, we see an emerging opportunity in a wide array of transaction structures, ranging from senior lending to leading bank regulatory capital relief transactions.

CONCLUSION

Our assessment of the investing landscape is consistent with the views we shared at the beginning of the year, and our conviction has increased that this cycle will be a deeper one. There will be complexity to navigate in this cycle, but we anticipate real depth and persistence over time of this growing opportunity set.

It is an incredible time to be a provider of capital and liquidity in credit markets – it has been many years, back to the GFC, since we have seen the confluence of stress and capital gaps developing simultaneously across the wide range of corporate, real estate and consumer credit that we follow globally across traded and private markets.

About the Authors

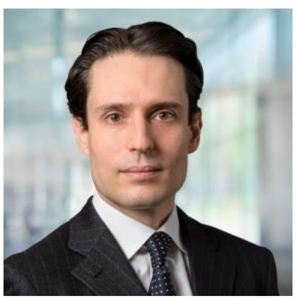
Ilfryn Carstairs
Partner, Chief Executive Officer and Co-Chief Investment Officer

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.

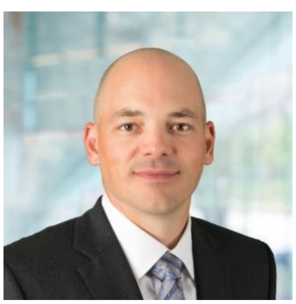


Giuseppe Naglieri
Partner and Co-Chief Investment Officer

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
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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 specializing in credit and credit-related assets. Founded in 1993, the firm has invested through multiple credit cycles, building on its roots in special situations and distressed to invest more than $95 billion across the credit quality and liquidity spectrum in both public and private markets. Värde currently manages over $13 billion in assets with teams in North America, Europe, and Asia Pacific focused on Corporate & Traded Credit, Real Estate, and Financial Services. For more information, please visit www.varde.com.

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