

VÄRDE

Värde Views: Opportunities in 2023

Credit Market Update

January 2023

Värde Views: Opportunities in 2023

INTRODUCTION

Värde Partners CIOs Ilfryn Carstairs, Brad Bauer and Giuseppe Naglieri, reflect on credit markets, areas of opportunity and how they see the current cycle shaping up as we start off 2023 in a position of further uncertainty around inflation, rates and the cost of capital around the world.

Please note that these views were authored at the end of Q4 2022 as part of our quarterly communication with investors and may have evolved since their publication.

The final quarter of 2022 provided some relief from the weak and volatile conditions seen for most of the year. While the drivers of the strength were clear – slightly more benign inflation readings in the US, slightly more moderate language out of the Fed and easing of the Covid-zero policy in China – to us the backdrop heading into 2023 remains difficult and the market is now pricing a path that seems too optimistic given the risks, particularly after a very strong start to 2023. More recent positive data improves the chances of a soft landing to some degree, but this now seems heavily discounted in market prices. Meanwhile a more significant recession remains a distinct possibility and now holds greater risk to the downside.

While this perspective applies on average across the market, when we look at the micro of the opportunity set across our platform, we are much more enthusiastic about the pricing that we see. Liquidity in credit, primary and secondary, remains very poor and, as such, there is opportunity where the resultant capital gaps mean that pricing is significantly more attractive than market averages would suggest. This leads to places – in both private and public markets – with excess returns to be had from being a liquidity provider, more than a credit risk taker.

Heading into 2023 this makes for several areas of attractive opportunity, balanced against others where we remain very cautious. Much like in 2022,

a complicated picture and one for which the ability to look across the global relative value set is critical.

2023 OUTLOOK

The Economy and Macro

Many volumes have now been written on the ins and outs of the macro environment in which we currently find ourselves. As ever, we aim to provide a summary of our own views rather than re-hashing all that material and we focus on the forces, and connecting logic, that we expect will end up driving the market next year. A simplified version of that logic and our view:

- Monetary policy looks set to remain tight, unless there is a recession, and rates markets price one already; broader asset markets, however, do not.
- Markets are pricing a Goldilocks scenario (lower rates without a major hit to the economy) but in doing so put central banks in a catch-22 – market strength adds support to keep policy tight.
- This creates particularly acute risks given the world's financial gearing and liquidity dependence – high financial leverage exacerbates the impact of tight financial conditions on the economy.
- On top of this, many sectors display very weak operating conditions – plenty of the global economy is already under strain.

- We see these combined factors continuing to lead to economic and financial stress in 2023 – stress takes time to develop. Companies and consumers built up liquidity buffers through '20 and '21. Monetary policy operates with a lag as debt costs roll up. Even mega-cycles like the GFC took many quarters to break open as the lag effects play through.

“Expanding on these key elements: in our view, the market seems too relieved by the recent respite in inflation data and the related assumption that there is now more certainty about the end point for central bank policy rates.”

- There are plenty of early warning signs of these impacts already and parts of the market that are pricing these conditions – this creates areas of immediate opportunity.

Expanding on these key elements: in our view, the market seems too relieved by the recent respite in inflation data and the related assumption that there is now more certainty about the end point for central bank policy rates. It could well be that inflation has mathematically peaked for this episode, especially given the recent moves in commodities and housing. However, the genie certainly appears to be out of the bottle and inflation is impacting behavior in a way that will (and should) make central banks cautious; not just worried about sequential data points, but also focused on ensuring it doesn't stay elevated or re-spike, as was the curse of the 1970s. The investing world has been attuned to thinking about risks as isolated episodes; risks peak and then risks clear. That certainly hasn't been the historical experience with fighting inflation once it takes hold, and we expect central bankers (already embarrassed by the complacency they showed with hindsight) to be very focused on the risk of recurrence.

It could also well be true that the policy rate caps out (as implied by rates markets) at around 5% in the US and 3% in Europe by the middle of this year. In this case, we still will have realized one of the sharpest tightening cycles in history, importantly, off a zero or negative starting point, such that the multiplier impact on the cost of financing would be even more pronounced than in past cycles.

The absence of major financial imbalances, such as we saw in the GFC, and a strong consumer and labor market should be supportive for the market thus also a force pushing against the Fed's tightening efforts, and meaning that higher rates, or a longer period at the highs, could still be on the horizon. Conversely, the set of outcomes required to achieve what the market is pricing seems to us highly difficult to achieve – a rapid rate rise, followed by rapid rate cuts, but with risk assets generally not pricing a recession of any severity. The case is illustrated by looking at the market implied path of U.S. Fed rates from here, which currently has rates peaking at 5% in mid-2023, before a rapid cutting cycle of 200bps down to 3% by the end of 2024.

The implied (by asset prices) soft landing case for the economy has a lot of downside to it. The world is at its most levered combined levels in history across governments, consumers and corporates, also coming off a period of historically easy liquidity in 2020 and 2021.

We expect this impact is coming with a lag for some parts of the economy. Traditional indicators of recession risk, such as yield curve inversion, are screaming that one lies ahead. Many elements of the data are showing weakness too. Consumers are now well towards burning through the savings reserves built up through Covid. Confidence levels are low. Housing markets globally are weighed down by the move in mortgage rates. Europe continues to struggle with badly elevated energy prices and both voluntary and involuntary rationing of power, affecting industrial production and competitiveness.

Rounding out our views on outlook, and returning to the catch-22 we mentioned above: if some version of economic weakness does not come to pass by

mid-2023, is it credible that central banks will begin cutting rates aggressively? We think not, and while we worry more about the economy than inflation at this point, both are important risks to the outlook over the coming years.

CYCLICAL DYNAMICS

Looking towards the credit market, we remain firmly of the view that we are in the beginning stages of a new cycle, as is already evident from the level of stress in credit conditions in many parts of the market. This should mean wider spreads and elevated stress and defaults in 2023. We expect a typical cycle: one where we see high yield defaults in the mid-to-high single digits and they take a good time to play through, usually 18 to 24 months. Very different from the recent Covid cycle.

In any cycle, as it plays through, there are relative winners and losers. The most heavily affected areas are those that face the “triple threat” for credit: higher financing rates, weaker operating conditions, and a sharp drop in liquidity provision from the market. When they are big enough, these pockets spillover and impact the cost and availability of credit in other healthier parts of the market. We see key early warning signs of important triple-threat sectors in European and Asian corporates, weaker parts of the global real estate markets and weaker sovereign and EM borrowers.

“The most heavily affected areas are those that face the ‘triple threat’ for credit: higher financing rates, weaker operating conditions, and a sharp drop in liquidity provision from the market.”

Beyond these sectoral warnings, the market generally is flashing red in several places. The valuation drops in the frothiest parts of the equity market and implosion of business models we see as predicated on speculative excess, such as those in the cryptocurrency space, speak to the sharp reduction in liquidity and risk appetite.

Credit markets have expressed this in a different way, with a sudden stop in liquidity provision in many important markets. US High yield issuance in 2023 was at its lowest level since 2008 and, despite the strong markets in the fourth quarter, only \$16 billion of high yield was issued for the period, despite the backlog from a very weak issuance year.

“...the real pipes of the credit market – warehouse lending, securitizations and the like – are also weak and even more impactful given their size and integration in the economy.”

While high yield is one of the more visible places for this, the real pipes of the credit market – warehouse lending, securitizations and the like – are also weak and even more impactful given their size and integration in the economy. AAA spreads across all forms of collateral have moved significantly in 2022 and issuance volumes are down sharply. In more economically sensitive collateral classes, such as subprime auto or CRE, AAA spreads moved as much as high yield in 2022 – for example, U.S. HY spreads were 135bps wider on the year, only modestly worse than the 115bps widening of AAAs in CLOs and the 55bps of subprime auto deals. A very unusual occurrence and one which has a magnified impact on the downstream funding cost for many financing-dependent credit and business models.

Credit Cycle Scenarios

After a transformative 2022, credit markets in 2023 are more interesting and complex to analyze than has been the case in many years. We believe we are at the start of a multi-year credit cycle, during which the availability of credit will be lower and its cost significantly higher than we saw prior to 2022. In the tug of war between the macro backdrop and credit quality deterioration, we see three potential scenarios.

Firstly, the outcome which we think is in the price today, is a smooth deleveraging in the context of a Goldilocks economic slowdown. Growth forecasts are relatively modest coupled with a projected rapid moderation in inflation. Even in this scenario, we would expect to see a multi-year deleveraging cycle with bumps in the road particularly in higher leverage or more squarely impacted segments of the credit market.

The second and scariest outcome for markets (in general and therefore also for credit) would be a continuation of the stagflation that began to emerge, where policy makers are unable to arrest inflation, yet growth continues slowing. In this scenario, further tightening would be required than is in the price and corporates would be pushed into faster and less orderly deleveraging. In 2022, corporates continued to benefit from a strong economic environment due to reopening effects and record margins. 2023 could be a more challenging proposition.

A third scenario is possible, although we think less likely than those above, in which a worse than expected recession could lead to much more severe deflation than currently expected. It seems hard to believe such a scenario could materialize, but it shouldn't be discounted. The Fed has been clear it would prefer this outcome to stickier inflation, and it has the power to engineer it. The main counterbalance to this potential outcome lies in the strength of labor markets globally. Deflationary deleveraging tends to be relatively good for credit as it enables eventual intervention by global central banks.

Across these outcomes we think there is significant potential for distress and dispersion. While it is still too early to predict the intensity of the deleveraging process, signals point to a severity between the 2015-16 cycle (which affected a few sectors acutely) and the GFC. The 12-month average spread of 485bps for high yield is well below the U.S. recession average of 970bps and implies a 2023 default rate only modestly higher to 2.8%. That said, as the impact of persistently tight monetary policy plays through, it is important to recognize that the current multiplier effect of the base rate movement has caused the biggest shock to corporate cost of capital in more than 30 years.

OPPORTUNITY SET

As we evaluate the investing landscape for 2023, we are optimistic about the here-and-now chance to buy good credit at cheap levels and the strong opportunity we expect to deepen with time. As we often say: averages deceive, and this is usually particularly true at the beginning of a cycle. While we are very selective in the type of risk we like now, we are seeing a wide-ranging and deep opportunity already in credit across our platform in both public and private markets.

As noted, we expect this to be a typical cycle, and as we outlined in 2020, we have developed a playbook that informs our approach to investing across a cycle. In short, at this stage of a cycle we prefer investments where the stress derives from liquidity gaps rather than credit risk, looking for investments where we believe we have downside protection regardless of the depth of the cycle. This cycle is global in nature, with many of the most significant sources of stress in Europe or Asia. More than any prospective cycle since the GFC, stress is building at the same time across corporate, real estate and consumer credit markets.

“Given the historic shift in liquidity conditions in credit, from feast in 2020 and 2021, to famine in 2022, we believe the opportunities to benefit from this stage of the cycle are even deeper than usual.”

Given the historic shift in liquidity conditions in credit, from feast in 2020 and 2021, to famine in 2022, we believe the opportunities to benefit from this stage of the cycle are even deeper than usual. This is particularly true for us in private markets where we benefit from the deep credit sourcing and origination platform we have built over the last decade.

The private market opportunity today is deep, though certainly not universal. Several global themes are at play in our pipeline. End markets that are very dependent on securitization or warehouse financing are seeing a large liquidity shortfall. This is leading to significant opportunities in the U.S. in both real estate and specialty finance. We have seen much wider spreads in secured real estate lending, as well as a spike in the need for rescue capital for real estate situations that are unable to rollover maturing capital structures. Homebuilding, a particular specialty of ours, is very capital starved both from liquidity and concern about the prospects of the industry. This is affording a very attractive opportunity to lend secured against high quality assets in this space.

In specialty finance there is a profound impact on many lenders from the steep increase in securitization funding costs, which plays directly through to their ability to maintain their balance sheet assets. Here we see opportunities to lend to these lenders, secured against whole loan assets, to buy or finance these assets outright and even to consider lending platforms that face an overall capital shortfall despite engaging in high quality lending as interesting acquisition targets outright.

In traded markets, average market pricing seems tight to us, liquidity is such that many market participants looking to access capital are accepting a very significant discount to do so. We see these discounts across new issue, hung deals and individual secondary credit selection in traded markets. There are many instances of good credit, with better characteristics than the index, that is trading hundreds of basis points wide of the average. This is a fundamental credit selection opportunity and is prevalent in both Europe and the U.S. across a variety of sectors, notably those where there is some consumer exposure (travel, leisure, etc.) or exposure to financing dependent businesses (consumer finance, real estate).

“While there has been a lot of press about the hung deal problem, less is written about the much bigger overhang in issuance markets: the sudden stop in bond sales last year.”

The selling of many of the hung deals by investment banks has cleared in an off-market fashion, with a small group of funds negotiating the terms of the sell down and anchoring the book. Being part of these processes has allowed us to capture the discount to market value as well as additional documentary protections and sizeable allocations of the deals we like.

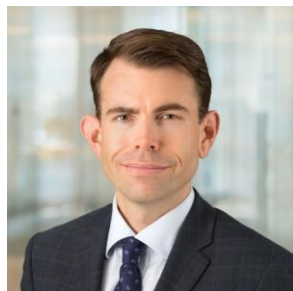
While there has been a lot of press about the hung deal problem, less is written about the much bigger overhang in issuance markets: the sudden stop in bond sales last year. In some sense the much bigger hung deal problem is the accumulation of issuers who are progressively being forced to issue. While there was not much of a maturity wall in 2022, we began seeing borrowers forced to the market towards the back end of the year, having waited as long as possible to deal with issuance to rollover debt. These borrowers again are paying a large discount to access liquidity which has given rise to a range of interesting deal opportunities. This problem will grow in 2023 if markets stay this way, and ultimately is a key driver of stress.

Amongst the biggest opportunities from this is in the European Financials space, an area we know particularly well. European banks are, in some sense, forced issuers as they must replenish regulatory capital buffers. The fourth quarter saw a rush of issuance across the space at very attractive yields and spreads and is one of the deeper opportunities we see globally. It is also a place of very major dislocation, confirmatory of the discount available in credit.

CONCLUSION

As we head into what we view as a traditional, wide-ranging credit cycle, we turn again to our well-worn investing playbook. We are staying selective at this stage about the types of credit risk we seek to take on, favoring quality and the chance to provide liquidity while avoiding situations that seem likely to get much worse before they get better. We do expect default rates to rise meaningfully as this cycle plays out. And so, we expect the time to focus on distress will come later, when much of the damage is done and the range of paths to recovery has narrowed. For now, however, uncertainty and downside risk are high, the range of outcomes is wide and we see the best relative value and risk/return in quality credits at good prices.

About the Authors



Ilfryn Carstairs

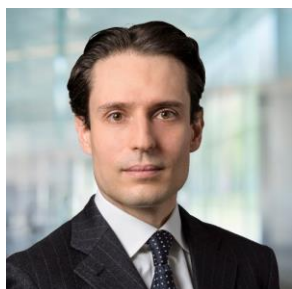
Partner, Chief Executive Officer and Co-Chief Investment Officer

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.



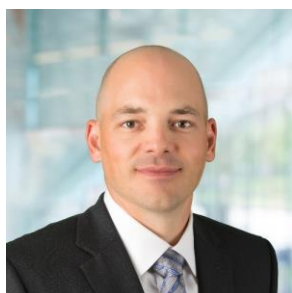
Giuseppe Naglieri

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 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.

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

520 Madison Avenue
34th Floor
New York, NY 10022
United States
+1 212-321-3780

Singapore

88 Market Street, #23-04
Singapore 048948
Singapore
+65 6579-0800