VÄRDE

Värde Views: 2025 Outlook and Opportunities

Credit Market Update

February 2025

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In this edition of Värde Views, Brad Bauer and Ilfryn Carstairs discuss the outlook for credit investing in 2025 amidst an increasingly unpredictable market environment. They examine the 'all else equal' conditions that form the 2025 baseline, discuss areas of potential dislocation, and highlight where Värde sees the most compelling opportunities in private and traded credit markets.

Please note that these views were adapted from our Q4 2024 quarterly communication with investors and may have evolved since their publication.

INTRODUCTION

Following a year in 2024 where we wrote regularly about our strong views on the market backdrop, most of which pleasingly played through, the contrast heading into 2025 feels stark. It would be a brave author who puts forward a certain case for how events will play out this year.

The driver of that shift, of course, is the U.S. political landscape and the much more unpredictable environment that coincides with the new administration. Unpredictability is not necessarily bad for markets, at least in the end as we saw during President Trump's first term, however, we now enter a period of determining the distance between campaign rhetoric and reality, and remaining vigilant ahead of new policy announcements.

While some of this uncertainty was reflected in pricing over the final weeks of 2024, the market generally seems to be forecasting a calm and relatively rosy set of outcomes. Valuations are near historic extremes, especially in equities, the U.S. Dollar is very strong, and rates markets are much more hawkish on the prospects of further cuts. Markets also implicitly appear to view the free-spending side of President Trump's agenda as much more likely to occur than a material cut in government spending, and that renewed tariff threats are more of a negotiating tactic than core policy.

This market setup seems extremely optimistic to us. Optimistic assumptions do not necessarily make market prices wrong. However, when a great outcome is in the price, even mild deviations from expectations can lead to volatility, and President Trump is calling for some very big deviations.

We believe the best way to approach the year is to consider the world as a two-part puzzle. The first part focuses on the foundational aspects of the economy, markets, and the opportunity set — the 'all else equal' conditions shaping the baseline for 2025. The second part considers the significant dislocations to this equilibrium that may arise from the Trump presidency.

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ECONOMIC BACKDROP

Overall, the global economy appears to be in a slightly weaker position heading into this year compared to this time last year, though we remain far from seeing a hard landing scenario, especially in the U.S.

U.S.: We see it as difficult for the U.S. economy to sustain the strong fundamentals it has delivered in recent years and, thus, expect some moderation in growth.

While the American consumer has been remarkably resilient, several warning signs continue to flash. Consumer credit remains tight and expensive by historical standards, and cost of living pressures remain high. The labor market has been very strong but weakened appreciably over 2024. Overarching everything in the U.S. economy is the level of pro-cyclical deficit spending, which is approaching wartime levels despite the strength of the economy.

Europe: The European economy has tended over an extended period of time to deliver sub-standard growth and 2025 seems to bring a heightened risk of a more significant recession. General industry remains under pressure, regulation remains high, and there is lower competitiveness associated with the step-change in energy costs since the breakout of the war in Ukraine and continued turmoil in the auto industry. Perhaps most important in a time where good policy is more acutely required, several major countries are grappling with weak or non-existent governments.

China: By contrast, China is perhaps a place where growth could surprise to the upside in 2025. Predicting this remains difficult as it relies heavily on a continuation of the more friendly economic policies that President Xi gradually, albeit cautiously, introduced throughout 2024. Despite these efforts, the Chinese economy continues to suffer from a broken residential housing market, and a slow transition to a consumer-led model from the traditionally capex and construction-heavy economy.

The global economy has shown remarkable resilience but remains heavily dependent on the U.S. In turn, U.S. growth has been helped by unsustainable levels of deficit spending, and cutting it is now in both political and market focus. However, we now find ourselves in a catch-22 of sorts – reducing the deficit appreciably will likely require the economy to take a hit in the form of lower spending, while failing to address it will quite likely drive a reaction in rates with similar effects.

Turning to monetary policy, the Fed's actions in 2024 increasingly appear premature relative to the strength of the economy and markets as well as the progress on the deficit. The rates market has already started reflecting, or perhaps forcing, a much more hawkish outlook for 2025.

As we consider the political environment, we view President Trump as likely to judge his success largely by the performance of the market and economy during his tenure. However, while the probability may be low, going too far on several of his campaign and post-campaign promises could lead to significant consequences. Furthermore, we expect Trump's focus on long-term results over short-term fluctuations suggests he may tolerate market disruptions as part of his strategy, signaling that a real selloff in part of the market could be forthcoming.

The sheer asymmetry of potential outcomes from some of Trump's stated policy positions informs our disciplined approach as we enter 2025. The key point to us remains our view that most of the market appears priced close to perfection, creating a dynamic where the potential upside is limited, but the downside risk is substantial, akin to a "heads you win a little, tails you lose big" scenario.

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CREDIT MARKETS

Credit markets generally returned to better health in 2024: issuance was strong, spreads oscillated around post-GFC tights in investment grade and high yield, ABS markets largely re-opened after a weak showing in 2023, and money was aggressively put to work in many areas of the private credit market, most notably in larger corporate deals, which were highly sought after by larger alternative firms looking to deploy the dry powder accumulated this cycle. There remained some important pockets of weakness, best exemplified by the most rate-sensitive segments of real estate – office and multi-family – where spreads stayed elevated and access to credit still severely diminished compared to prior periods.

Dispersion within traded credit was a notable characteristic of 2024, as a steady flow of special situations and restructuring deals hit the tapes. This remains an important part of the opportunity set that we highlighted last year, and one that continues to bear fruit and create further pipeline.

Rates markets have experienced a roller coaster ride over the past 24 months, and as we enter 2025, we find ourselves returning towards the peak of the range in 5-year and 10-year U.S. Treasuries with volatility still elevated. We expect this to be an area where expectations can be "beaten" if there is more downside or volatility in the economy and market.

For now, however, these levels of rates are perpetuating the issues in the credit cycle, while also feeding into the moderation of rate-sensitive sectors of the economy, such as housing via elevated mortgage rates.

In our view, the outlook for credit is quite constructive for 2025, but it is important to acknowledge the risks:

- First, the low probability of a recession and inflation being roughly under control could come under pressure. Recent price action in the rates market suggests that the Fed may have cut too aggressively out of the gate, and a scenario where the Fed refrains from further cuts will bring the math problem to the forefront for lower-quality issuers who have yet to tackle their refinancing. A new leg up in rates will create significant opportunity and dispersion putting further pressure on free cash flow.

- Second, tariff risks will come to the forefront in 2025. Sectors with the highest concentration of companies facing significant costs incurred in Asia, particularly in technology and cyclical consumer, are likely to face headwinds even if only some of the proposed policies are enacted.

- Finally, a shift to a weaker economic scenario cannot be discounted altogether. Hedging against such a scenario in credit is attractive in a historical context and is a key aspect of our portfolio construction toolkit.

OPPORTUNITY SET

Looking forward and despite signs of recovery in credit markets throughout the year, strong demand for capital persists with many borrowers still struggling to navigate today's current market conditions. Upcoming maturities and the need to address their capital structures continue to present opportunities to create risk in idiosyncratic scenarios with strong downside protection. This is true in both private and public markets.

The market also appears primed for increased activity in 2025. M&A volumes have been somewhat depressed in recent years and real estate acquisition activity has been especially limited. These trends are unlikely to persist for much longer in our view, as maturities, if nothing else, will drive action in the coming year.

Furthermore, we constantly consider the possibility of experiencing a proper dislocation or market stress. Uncertainty remains reasonably high, yet optimism reigns supreme as we enter 2025. The likelihood of a more significant dislocation over the next 12-18 months, driven by policy misstep or otherwise, has grown materially in our view. Bearing this perspective, we maintain strong conviction across several segments in both private and traded credit markets and offer the following thoughts on the opportunity set.

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Private Markets

Commercial Real Estate: The CRE market continues to grapple with assets requiring deleveraging, a challenge further exacerbated by the recent uptick in rates. This cycle in CRE continues to be slow-moving, particularly in office and subsets of other major CRE sectors, which are likely to become increasingly relevant in 2025. We continue our bias toward the top of the capital structure, with a preference for senior lending secured by higher-quality and newer assets – opportunities where we can often create risk at levels either commensurate or better than where subordinated capital is pricing. We remain active across the U.S. and have recently begun to see opportunities in Europe pricing at attractive levels for the first time in many years.

Capital solutions for over-levered structures requiring higher advance senior, mezzanine, or preferred investment have become an increasingly relevant opportunity. Across our platform, we hold high conviction in themes including student housing, medical office, and select hospitality assets. We anticipate that the opportunities in these themes may very well grow over the coming year.

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Housing: As long-time investors in the housing sector, the current market conditions have been years in the making, and we can use history as an important guide. The juxtaposition of a persistently undersupplied U.S. market against a backdrop challenged by affordability, partly driven by rates and home prices, leaves us cautiously constructive. We remain active in the residential market but are highly selective in our choice of homebuilding partners, markets, and micro locations. We anticipate new home sale volume will remain a critical datapoint and have, thus far, been encouraged by the disciplined approach taken by builders to address the relatively challenging backdrop.

Asset-Based Finance: One area of the market that has maintained a consistently attractive risk premium over the past several years is asset-based finance. While the balance of supply and demand in the space will inevitably have marginal influence as more capital is raised, we believe demand for non-bank capital will continue to maintain or even outpace the amount being raised. Beyond this macro viewpoint, broader risk considerations inform our views on specific segments that stand out in today's market, such as the current backdrop for consumer credit.

We have developed a strong preference for more substantial credit protection, mainly through elevated first-loss capital from the borrower, while maintaining flexibility between recourse and non-recourse structures. In particular, we find originators with well-established businesses and lending products, yet limited or no access to securitization markets, to be particularly attractive.

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Asia Pacific Private Credit: Within our Asia Pacific private credit strategy, we continue to focus on opportunities in excess spread situations centered on real assets and business with predictable, contracted cash flows. Our pipeline is robust and continues to grow. India remains the most notable market as large, globally significant transactions with high asset coverage and large acquisition finance transactions represent the main sources of pipeline. We are also seeing compelling opportunities in Australia and Southeast Asia, particularly in the resources and real asset sectors. Looking ahead, we are optimistic that 2025 will be a strong year, marked by an increase in transaction volume.

Traded Markets

LMEs / Refinancings: The pipeline of stressed corporates approaching their maturity continues to be a rich source of opportunity for us in 2025. Spread tightening aside, it is the combination of higher-for-longer rates and weakening corporate fundamentals across multiple sectors that leave many capital structures without viable refinancing options, leading to increased dispersion between the "haves" and "have-nots" in credit.

We continue to find the best value in situations where we can act as a hybrid provider of capital solutions. Structuring and legal complexity serve as a significant barrier to entry, meaning value has remained much stickier than in general high-yield situations. Our ability to trade both the secondary paper and participate in new money financing opportunities requiring complex structuring and underwriting positions us to lead transactions in this ever-expanding segment of the market.

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Post-LME Instruments: A natural continuation of the aforementioned theme, post-LME situations offer ironclad documentation and plenty of maturity runway in our view. Such situations often allow investors to focus on fundamentals while minimizing legal risks. Post-LME capital structures tend to be highly tranched, allowing for flexible positioning (from high quality, high carry opportunities to equity-like situations with significant convexity), allowing us to participate based on our views on the company and broader industry prospects.

Corporate Restructurings: We remain optimistic about the go-forward opportunity in traditional corporate restructurings. We maintain our view that the current restructuring opportunity set is less attractive

on a relative value basis compared to downside-protected returns achievable in first-lien, money-good situations. However, over time, we anticipate that additional higher-quality issuers will reach the point where LMEs and stressed financings are no longer sufficient for their capital structures, and it becomes evident to all stakeholders that a more comprehensive restructuring is needed to put the business on a firmer footing.

Given our long-standing expertise in restructurings, we believe we are well-positioned to capitalize on these opportunities when the timing and conditions align.

Disrupted Sectors:

- Telecom: The stressed and distressed universe within the telecom sector grew significantly across several sub-segments, including fiber, legacy telecom operators, and satellites. This is unsurprising given the sector's capital intensity and heavy reliance on leverage during the previous era of near-zero rates, which has been challenged by today's higher-for-longer rate environment. While we recognize there are structural issues in certain corners of the sector, we like its asset-heavy nature and the supportive long-term demand trends in data usage and high-speed broadband penetration.

- Auto: We expect a sizable increase in stress within the auto sector in 2025, particularly in Europe. The European auto industry faces a complicated environment, where long-term threats (structural over-capacity, loss of market share to Chinese peers, EV transition risks) interact with cyclical issues linked to lower demand. The space is characterized by numerous small to medium-sized capital structures where we believe there are opportunities to create value by properly identifying the winners and losers. Ultimately, we expect both an uptick in defaults and a fertile opportunity to trade the higher-quality names, while remaining patient as we expect conditions may worsen before they get better.

- Healthcare: The U.S. healthcare sector, particularly, has faced significant challenges in recent years, including the lingering effects of Covid and rising labor costs. These dynamics have created compelling opportunities in high-quality companies that were over-levered and whose debt traded at dislocated levels. While the sector has experienced some normalization of late, there are still companies that have yet to address their capital structures. This, coupled with potential policy shifts under Trump – particularly regarding insurance – should lead to new and interesting opportunities to invest in the healthcare space.

- Food: This sector has experienced notable dislocation as a result of secular trends (i.e., growing demand for healthier food), a softening of consumer spending in certain segments, and the introduction of new GLP1 weight-loss drugs. Similar to healthcare, we believe 2025 will present more opportunities in this sector as many companies still need to address over-levered capital structures.

CONCLUSION

While we believe that taking a more disciplined stance for the early part of the year will be prudent, we expect to find plenty of opportunities in well-protected situations or those with low correlation to the broader market within what is a robust pipeline at the start of 2025.

Our platform is built to navigate a range of markets and geographies and there currently exists a solid opportunity set, particularly driven by the large number of "have-nots" still struggling to navigate this higher-rates environment, coupled with the growing likelihood of a more significant market dislocation. Ultimately, successfully navigating the transition from today's market to one marked by increased uncertainty requires an approach that is both versatile and adaptive.

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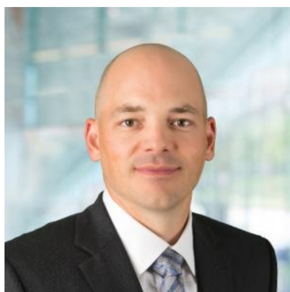
About Värde Partners

Värde Partners is a leading global 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 and currently manages $17 billion in assets. With local investment teams and partnerships in North America, Europe and Asia Pacific, Värde invests across private and public markets with a focus on real estate, asset-based finance and corporate credit. For more information, please visit www.varde.com.

About the Authors



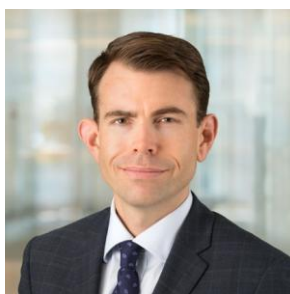
Brad Bauer
Managing Partner and Chief Executive Officer

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

Brad joined the firm in 2007, was named Partner in 2013 and has served as Chief Executive Officer since 2023. From beginning his career at Värde on the Corporate and Traded Credit team to later leading the firm's private credit strategies, Brad has held a variety of leadership positions working out of the firm's U.S. and U.K. offices. His extensive investing experience spans numerous industries in public and private 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.



Ilfryn Carstairs
Partner and Co-Executive Chair

Ilfryn Carstairs is a Partner and Co-Executive Chair of Värde. He is a member of the firm's Investment Committee. Based in Singapore, he joined the firm in 2006 in London and was named Partner in 2011. He previously served as CEO of the firm. Throughout his career, he has invested across a wide spectrum of financial assets ranging from corporate restructurings and liquidations to more actively traded opportunities.

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.

Offices

New York

520 Madison Avenue
34th Floor
New York, NY 10022
United States

Minneapolis

350 N Fifth Street
Suite 800
Minneapolis, MN 55401
United States

London

2 St James's Market
London SW1Y 4AH
United Kingdom

Singapore

88 Market Street, #23-04
Singapore 048948
Singapore

Mumbai

#77, 3 North Avenue,
Maker Maxity
Bandra Kurla Complex
Mumbai 400051
India