

Credit Market Update: Credit Markets trying to find their footing

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London 29 November 2022 – After markets enjoyed a brief technical rally over the summer, the third quarter resumed 2022's downward trend. Higher rates and inflation continue to serve as the primary drivers of market volatility, with energy concerns in Europe, and the economic situation in the United Kingdom, factoring in significantly.

The recent disturbances in the UK Pension Liability Driven Investment (LDI) portfolios demonstrated that volatility could appear in unexpected places, with markets still somewhat reliant/expectant that governments or central banks will step in to solve problems while simultaneously fighting inflation. We do not expect these factors to abate this year.

Risk assets, as well as perceived "risk-free" assets, largely posted another negative quarter in Q3, though October provided some relief. We have touched bear-market territory in 2022 for both equities and investment grade credit, a phenomenon we have not seen in our lifetimes. We see this as a significant signal shifting value from equity to credit.

Credit metrics are at historically attractive levels

We are now in a period where yields (9%+) and prices (low-80s) are at sustained levels we have not seen since the 2009 European sovereign debt crisis (yields) and the 2008 global financial crisis (prices). This excludes the few weeks in 2020 when Covid sent market levels wider than they are today. Given the movement in rates, spreads have been re-tracing their path since the summer, but remain inside of June's wides of ~700.¹ Our current expectation is that spreads have room to widen but, in our opinion, are unlikely to do so aggressively, absent a material exogenous shock.

The credit market is trying to find its footing

Looking back at this year, 2022 has been very light on credit issuance given market conditions and steadily increasing rates. European non-financial gross bond issuance stood at €23bn as of early October, compared to €122bn for the same period in 2021, and an average of over €80bn per year since 2013. 2022 issuance levels are trending towards the '06 – '09 time frame for European high yield.² European net high yield issuance (issuance minus maturities, redemptions, etc.) is barely positive this year and GBP high yield issuance is net negative, something we have not seen since 2008 in European markets. The situation for US high yield is not materially better, with year-to-date issuance tracking at similar levels.

Capital markets have recently been attempting to revive primary issuance in both the US and Europe, with some deals succeeding and others attempting to issue, only to retreat and regroup. Nonetheless, in the past few weeks, the market seems willing to price senior secured risk for quality companies in the 10%+ range.

In the quarter, we've seen a slow, but steady flow of primary deals for higher quality companies seeking to address upcoming maturities, in spite of higher interest expense for the next few years. Most of these deals are objectively attractive from a yield perspective, especially for senior secured risk.

Sponsor activity is muted, but catalysts are surfacing

Volatile market conditions often result in corporate activity ceasing as management teams take a wait and see approach before acting. The cautious resumption of primary activity can be a positive sign for functioning capital markets, and we see evidence of corporate activity in situations involving:

- Sponsors tendering or retiring debt at par or a discount higher than current trading levels
- An uptick in cross-border M&A (in particular USD buyers of EUR and GBP assets)
- Sponsor to sponsor M&A activity
- Larger, investment grade company M&A of smaller leveraged companies
- Sponsor support and engagement on capital solutions

Our expectation is that catalyst volumes should increase in the coming quarters. Right now, there is not a market-wide, pressing need for refinancing activity, given the volume of issuance in 2020/2021. However, companies with

¹ Source: Bloomberg, 28 October 2022

² Source: J.P. Morgan Credit Research, 7 October 2022

2023-2024 maturities on the horizon will likely end up engaging with lenders to solve for those refinancing needs. In addition, we expect USD-backed sponsors and corporates to take advantage of decades-low exchange rates, which have made EUR and GBP based companies 15%-20% cheaper in USD terms over the past year.

The market opportunity in European CLO Debt

The European CLO market has grown steadily since the global financial crisis, approaching a total market size of ~€200bn across 60 managers. In a negative rate and now rising rate environment, investors have been drawn primarily to the yield pickup for similar ratings as corporate debt. CLO debt also offers potential protection from inflation via floating rates for most liabilities, diversification of underlying credit risk, and, importantly, a historically low default rate, driven primarily by the protections embedded in the CLO structure. These rules limit exposures to lower rated securities and have mechanisms that trigger to protect liability principal in difficult markets, implying a sustained default rate in excess of 2008-2009 levels would be required before B/BB rated tranche principle would be impaired.

As a result, we have seen market liquidity steadily increase with a mix of real-money buyers and opportunistic investors, primarily based in the US. The complexity of the structure, and historical tendency for the market to widen suddenly are part of what keeps the investor base relatively narrow and best suited for deep, fundamentally driven credit firms. The key with CLO debt, as with many asset classes, is properly matching the duration of capital and the ability to withstand market volatility.



David Allen is the Managing Partner and Chief Investment Officer at AlbaCore Capital Group.

Mr. Allen has nearly 30 years of financial services and investment experience, with a focus on the High Yield and Leveraged Finance Markets.

Prior to founding AlbaCore Capital Group, Mr. Allen managed Canada Pension Plan Investment Board's European Principal Credit Fund and was a member of the Investment Committee. Mr. Allen was also a Partner, Investment Committee member and Senior Portfolio Manager at GoldenTree Asset Management, where he established and ran the firm's European presence. Mr. Allen spent a decade with Morgan Stanley in New York and Hong Kong, working across M&A and investment banking before specializing as a High Yield media analyst.

Mr. Allen graduated from the University of California, Berkeley, where he earned a Bachelor of Arts in Economics and was an all-conference rower.

About AlbaCore Capital Group

AlbaCore Capital Group is one of Europe's leading specialist credit investors focusing on public and private corporate credit markets. The senior investment team have been investing with this hybrid strategy for over a decade. Founded in 2016, AlbaCore has invested over ~\$23bn^[1] for global pension funds, sovereign wealth funds, consultants, insurance companies, family offices and endowments.

AlbaCore is focused on consistently outperforming the market in the long term while protecting investor capital. The credit selection process is based on fundamental research with a focus on capital preservation, ESG factors and risk-adjusted returns.

Headquartered in London with offices in New York and Dublin, AlbaCore has a partnership approach with values at the center of the AlbaCore community.

www.AlbaCoreCapitalGroup.com

[1] Invested capital is the sum of all 'buy' trades for all AlbaCore mandates since inception to 30 September 2022 and includes recycled capital and co-investment.

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