Alternative Credit: 3Q23 Review

Markets continued to struggle in their efforts to get a read on the trajectory of monetary policy normalization, and a number of asset classes were whipsawed over the course of the third quarter as a result. Duration-sensitive assets were particularly hard-hit as long-dated Treasuries sold off sharply.[1]

First Eagle's quarterly Alternative Credit Review provides an update on the investment environment for alternatives and a closer look at key asset classes managed by the First Eagle Alternative Credit and Napier Park teams.

The Federal Reserve hiked its federal funds target rate by 25 basis points in July, bringing it to a range of 5.25–5.5%, While the central bank left its policy rate untouched in September, new economic projections released at that meeting suggested another 25-basis-point hike is likely before the end of 2023; however, it was the updated 2024 forecast that seemed to have a greater impact on sentiment. The median end-2024 projection for the fed funds rate now stands at 5.1%, up from 4.6% in June—a hawkish shift from four cuts to two—and a range of macro indicators released during the quarter have further supported the Fed's insistence that investors should expect policy rates to be "higher for longer."[2]

With the terminal point of the current rate-hike cycle seemingly in sight, two-year Treasuries traded in a tight range during the quarter. In contrast, 10-year bonds climbed about 80 basis points, with nearly two-thirds of that move occurring in September.[3] Stable short rates combined with a selloff in long bonds to produce a fairly rare phenomenon known in bond circles as a "bear steepener." Tighter financial conditions are among the potential implications of a bear steepener and add to concerns about the impact a higher-for-longer scenario would have on free cash flow, interest coverage and other corporate credit metrics.

1. Source: FactSet; data as of September 30, 2023.
2. Source: Federal Reserve; data as of September 20, 2023.
3. Source: Federal Reserve Bank of St. Louis; data as of September 30, 2023.

Rhetoric from the Fed suggests the central bank is still hopeful for a soft landing, but the prospects of such an outcome do not appear any more certain now than they have been throughout this tightening cycle. Inflation has eased considerably, but it remains above the central bank's target, and energy costs, housing prices and tight labor markets are all fighting against the Fed. While the economy has been resilient thus far, persistence is not guaranteed, and conditions could likely become more difficult as the accumulated impacts of policy tightening continue to reverberate. Combined with a higher-for-longer cost of capital, credit fundamentals may face further challenges. Meanwhile, a range of other factors—including domestic politics, geopolitics and various armed conflicts—continued to weigh on investment conviction.

Broadly Syndicated Loans: Technicals Have Provided Support

Borrower fundamentals held fairly steady during the third quarter. Loan defaults by volume—a backward-looking indicator—have risen steadily throughout the Fed's hiking cycle but eased during the third quarter as several defaults fell off the 12-month calculation period; notably, default rates continued to be higher for non-sponsored borrowers than for their sponsored brethren.[4] The distress ratio—a forward-looking indicator that reflects loans trading for less than 80 cents on the dollar—also pulled back during the quarter for calculation reasons, though it remains above its five-year average.[5]

Rating agencies, meanwhile, maintained their pessimistic outlook for credit performance going forward, with downgrades exceeding upgrades at a ratio of 1.73x.[6] Lower ratings tend to curb the demand for loans, and a bias toward downgrades typically results in greater price volatility, less new issuance and more refinancing challenges.

While we have seen a slow deterioration of credit fundamentals over the course of the rate-hike cycle, technical factors have been quite supportive of the broadly syndicated loan market. Though new-loan issuance in the third quarter accelerated to a rate not seen since the Fed began its rate-hike cycle in early 2022, year-to-date volume stood at its lowest level since 2010 thanks to a sluggish recovery in non-refinancing loan activity. Institutional issuance came in at $76 billion for the third quarter, with refinancings accounting for about half of this activity. Loan issuance to back mergers and acquisitions (M&A) perked up somewhat but—like new issuance in aggregate—continued to lag badly from a year-to-date standpoint, and the uncertain trajectory of policy and the economy appears to be weighing on this key source of capital demand.[7] Refinancings and amend-and-extend activity, which is not included in the new-issuance figure cited above, continued to be robust and has further improved what already was a non-threatening maturity wall.[8]

> Year to date, new-loan issuance stands at its lowest level since 2010 thanks to a sluggish recovery in non-refinancing activity.

Demand for loans—historically driven by a combination of collateralized loan obligation (CLO) formation and retail fund flows, with the former typically the much larger contributor—improved quarter to quarter off very depressed levels. The lack of CLO formation has been a key factor in the tepid demand for loans for the past several quarters. With loan prices migrating upwards and financing expensive, the economics of these structures—particularly in the junior tranches—has left investors waiting for better entry points. Another CLO-related source of near-term consternation for loan demand and liquidity is the unusually large percentage of outstanding CLOs exiting their reinvestment periods between now and year end.[9] That said, CLO issuance did improve somewhat during the third quarter, as short-term loan market weakness enabled managers to ramp up their warehouses with more favorably priced loans.

4,5,6,7,8. Source: PitchBook | LCD; data as of September 30, 2023.
9. Source: Fitch Ratings; data as of August 22, 2023.

Notably, while the formation of broadly syndicated CLOs are off sharply from pre-2022 trends, year-to-date volume of middle market/private credit CLOs is about double that of the same period last year. Loan retail funds, meanwhile, saw modest inflows during the third quarter after five consecutive quarters of outflows; year-to-date flows remain decidedly negative, however.[10]

Middle-Market Direct Lending: Finding Opportunities to Put Money to Work

Similar to the activity in broadly syndicated loans, the pace in the middle market direct lending has picked up somewhat, though sluggish M&A remains a headwind. Though M&A activity has slowed, there has been a notable uptick in borrowers looking to private lenders to refinance outstanding leveraged loans and high yield bonds, sometimes at deal sizes once considered highly aspirational.[11]

Though direct lending typically costs the borrower more than a syndicated loan, it comes with a greater certainty of closing as well as a limited number of creditors to negotiate with. From a market perspective, this source of refinancing capital may be keeping spreads tighter than fundamentals would seem to dictate and potentially may impair loan market liquidity.

Credit Derivatives: Demand for Downside Mitigation Can Result in Exploitable Price Inefficiencies

Credit-default swap (CDS) indexes are baskets of single-name credit-default swaps, or derivative contracts that offer a counterparty protection against a credit event—such as a missed payment or bankruptcy—impacting the issuer. CDS indexes are issued on a basket of underlying credits and have standardized fixed coupons, payment dates and maturity dates. They are among the most liquid indexes in the credit markets, providing investors with a scalable, cost-effective way to hedge credit exposures or to express a view across a specific market segments.[12]

> CDS indexes often are the most efficient credit instruments to trade during periods of market stress, which may create opportunities for active investors.

A buyer of credit protection through a CDS index essentially is taking a short position on credit risk, with the quarterly fixed index coupon payment akin to an insurance premium against a deterioration in credit conditions. A credit protection seller, in contrast, is taking a long position on credit risk, assuming the credit risk of the index's constituents in exchange for a quarterly coupon payment. In addition to these basic trade opportunities, some indexes also are divided into tranches whose performance is defined by seniority in the index loss distribution—from equity to mezzanine to senior to super-senior—allowing investors to fine-tune their risk/reward exposure. Recent years have also seen growth in CDS index options or "swaptions," contracts that give the owner the right to enter into a CDS index position at expiry at a specified strike price.

The most popular CDS indexes are the Markit North American High Yield CDX Index (CDX HY Index) and Markit North American Investment Grade CDX Index (CDX IG Index). The market for these credit derivatives is substantial compared to traditional credit asset classes. For example, trading of the CDX HY Index, its tranches and options represent approximately 45% of all high yield credit trading, compared to 25% for single-name cash bonds 13% for exchange-traded funds.[13] Notably, CDS indexes often are the most efficient credit instruments to trade during periods of market stress and tend to attract particularly high volumes during these times as a result.

10. Source: Morningstar Direct; data as of September 30, 2023.
11. Source: PitchBook | LCD; data as of September 30, 2023.
12. Source: IHS Markit; data as of November 2021.
13. Source: JP Morgan, Bloomberg, Depository Trust and Clearing Corporation, SDR, FINRA; data as of July 26, 2023.

Default-rate expectations and the loss given default of an index's underlying issuers are the main determinants to pricing and intrinsic value in credit derivative markets, but pricing is also highly sensitive to supply and demand technicals. The popularity of the CDX HY Index among investors looking for a fast, scalable way to gain long and/or short exposure to high yield credit has resulted in a tendency for the index to overshoot fundamentals as market participants seek to position themselves in strongly directional markets. In weaker credit markets, such as we are experiencing today, this dynamic often has had the unintended consequence of flattening the yield spread curve as investors seeking what they perceive to be the "cheapest" source of downside mitigation in a falling market buy short positions in indexes with shorter-dated maturities. Such flattening tends to reveal pricing inefficiencies that active investors can attempt to capitalize on.

Indexes are typically issued with tenors of five years, and "roll" every six months in March and September, at which point a new index is created with an updated set of constituents; while older series continue trading until maturity, these on-the-run series tend to offer the greatest liquidity.

Real Assets: Conditions Appear to Favor Existing Railcar Fleet

Railcar lessors help meet the needs of companies that want to move freight across rail lines without the capital cost of railcar ownership. For investors, railcars are long-lived, cash-flowing transportation assets with a track record of relatively low correlation with broader financial markets. We believe they represent an attractive strategic exposure for a variety of portfolios.[14]

Higher inflation and interest rates generally are supportive of railcar leasing and the value of the existing railcar fleet. Railcars are relatively fungible items; leasing demand for existing railcar, as opposed to buying a new one, increases as elevated labor and material costs push new-railcar prices higher and the higher cost of capital makes financing more expensive. Recent performance in this space has highlighted this dynamic.

> Economic conditions in North America during 2023 have been highly supportive of demand for most railcar types, and high interest rates have boosted the appeal of leasing.

Economic conditions in North America during 2023 have been highly supportive of demand for most railcar types, particularly as onshoring and localized trade gains prominence, and lessors generally garnered higher rents for their railcars as a result. For example, the GATX Lease Price Index averaged 31% growth during the first and second quarters of 2023 while Trinity's Future Lease Rate Differential averaged 37%.[15] Meanwhile, the higher cost of capital has increased the appeal of leasing railcars relative to buying and financing them.

Supply, meanwhile, has been constrained by several factors. The tight labor market, continuing supply-chain issues and higher input and financing costs have kept new railcar production shy of the level at which railcars are being taken out of service. Reflecting this tightened supply, the number of available "parked" railcars in the North American fleet has declined by 30 percentage points since the Covid-related peak in June 2020.[16]

14. Source: Umler; data as of January 31, 2023.
15. Source: Company reports; data as of June 30, 2023. The GATX Lease Price Index is a weighted-average lease-renewal rate for a group of railcars representative of the company's North American fleet. Trinity's Future Lease Rate Differential calculates the implied change in lease rates for the company's railcar leases expiring over the next four quarters. Data released by GATX and Trinity—large, publicly traded participants in railcar leasing—are often considered representative of trends in the industry.
16. Source: AAR/Railinc; data as of June 30, 2023.

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Risk Disclosures

All investments involve the risk of loss of principal.

Alternative investments can be speculative and are not suitable for all investors. Investing in alternative investments is only intended for experienced and sophisticated investors who are willing and able to bear the high economic risks associated with such an investment. Investors should carefully review and consider potential risks before investing. Certain of these risks include:

- Loss of all or a substantial portion of the investment;
- Lack of liquidity in that there may be no secondary market or interest in the strategy and none is expected to develop;
- Volatility of returns;
- Interest rate risk;
- Restrictions on transferring interests in a private investment strategy;
- Potential lack of diversification and resulting higher risk due to concentration within one of more sectors, industries, countries or regions;
- Absence of information regarding valuations and pricing;
- Complex tax structures and delays in tax reporting;
- Less regulation and higher fees than mutual funds;
- Use of leverage, which magnifies the potential for gain or loss on amounts invested and is generally considered a speculative investment technique and increases the risks associated with investing in the strategy;
- Carried interest, which may cause the strategy to make more speculative, higher risk investments than would be the case in absence of such arrangements; and
- Below-investment-grade loans, which may default and adversely affect returns.

Definitions

One cannot invest directly in an index. Indexes do not incur management fees or other operating expenses.

Broadly syndicated loans (BSLs) are loans extended by a group of financial institutions (a loan syndicate) to a single borrower. Syndicates often include both banks and nonbank financial institutions, such as collateralized loan obligation structures, insurance companies, pension funds or mutual funds.

Collateralized loan obligations (CLOs) are financial instruments collateralized by a pool of corporate loans.

Credit-default swaps (CDSs) are financial derivatives in which the buyer of a swap contract transfers the credit risk exposure of a specified debt issuer (i.e., the "reference entity") to the seller of the contract in exchange for fixed premium payments.

A **credit rating**, as represented by credit quality breakdown, is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of a debt issuer's creditworthiness of an issuer with respect to its obligations, including specific securities, money market instruments or other bonds.

Federal funds rate is the interest rate at which depository institutions (banks and credit unions) lend reserve balances to other depository institutions overnight on an uncollateralized basis.

GATX Lease Price Index is a weighted-average lease-renewal rate for a group of railcars representative of GATX Corporation's North American fleet. As GATX Corporation is a large, publicly traded participant in railcar leasing, its data are often considered representative of trends in the industry.

Markit North American High Yield CDX Index (CDX HY Index) is composed of 100 of the most liquid North American entities with high yield credit ratings that trade in the credit-default swap market.

Markit North American Investment Grade CDX Index (CDX IG Index) is composed of 125 of the most liquid North American entities with investment grade credit ratings that trade in the credit-default swap market.

Trinity's Future Lease Rate Differential calculates the implied change in lease rates for the Trinity Industry's railcar leases expiring over the next four quarters. As Trinity Industries is a large, publicly traded participant in railcar leasing, its data are often considered representative of trends in the industry.

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