Private credit: mid-year outlook

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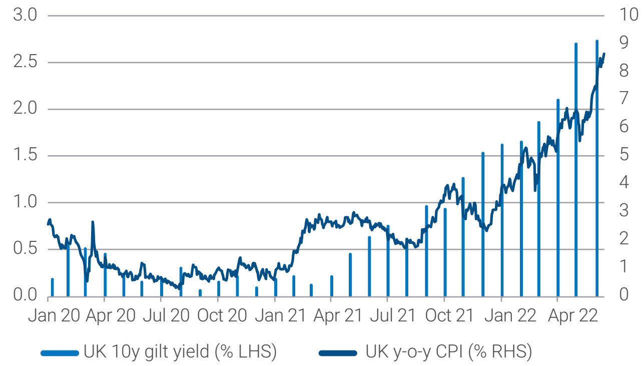
Introduction

In our market outlook at the start of the year, we noted that investors should prepare for the unexpected, since we believed the road ahead was unlikely to be smooth. We were correct in our thinking, but not in the way we envisaged. The Ukraine conflict sent inflation to record highs, which has led to a cost-of-living crisis and heightened recession risk in Europe and the US. Public equities and bonds suffered significant losses in the first few months of 2022, while commodities outperformed.

Figure 1. On the rise: inflation and yields



Source: Bloomberg as at 13 June 2022.

What might happen in the second half of 2022 in European private credit markets? The LGIM Asset Allocation team's mantra "prepare, don't predict" feels more apt than ever, as does our private credit team's investment philosophy "credit, structure and pricing". We remain selective and agile in our approach, while stress-testing both new opportunities and our existing portfolio for a variety of outcomes.

Against this background, here's an update on the private credit market, as well as our three main themes for the year:

How has private credit performed?

Despite a turbulent first half of the year for public equity and fixed income, private credit has appeared relatively resilient. Issuance of floating rate and short-duration assets increased, and such assets have performed relatively well.

As expected, on account of their illiquidity, spread movements in private credit lagged those of public markets during the first few months of the year but have since widened to more attractive levels, in our view. Over recent months, we have found the best priced opportunities in the real estate, alternatives and crossover debt spaces.

The start of the year saw the return of those borrowers who had postponed their debt-raising plans due to the pandemic, alongside other borrowers keen to lock in lower rates. Despite the macroeconomic uncertainty, strong issuance levels and a broader base of corporate issuers in the first half of 2022 have been positive for portfolio diversification. However, we have also seen some borrowers delaying their capital-raising plans which should add to the pipeline going forward.

Demand from investors, meanwhile, has remained strong. Private credit fund managers have deployed some cash and US investors have increased their presence in the European market to take advantage of the strong dollar.[1] High-quality issuance continues to be oversubscribed and investors have tended to be more inclined to accept a lower spread rather than a weaker debt structure. With increased uncertainty around the economic outlook, the value in retaining strong downside protection has increased for investors.

1. Source: Burgiss Global Private Capital Performance Report, Q1 2022.

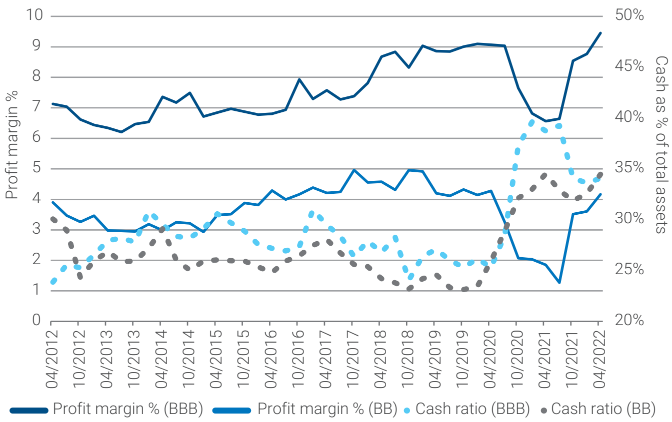
Higher rates and inflation

- Interest rates and inflation have dominated market returns year-to-date. Despite widening spreads, the credit market has been relatively resilient overall, and defaults so far have stayed low (see Figure 3). Short-duration assets have outperformed long-duration assets. For liability-driven investors, we believe the increase in bond yields represents an opportunity to de-risk at better prices.

- Corporate fundamentals and debt servicing capacity were strong going into 2022 but higher costs will continue to put pressure on corporates and development projects.

- We expect aggregate corporate margins to be challenged, since not all price increases can be passed onto customers. However, sectors with inelastic demand, strong pricing power and more fixed costs as a percentage of total costs will be better positioned, in our view.

Figure 2. European corporate profit margins and cash balances



Source: Bloomberg. Analysis is based on the constituents of the ICE BofA BBB Euro Non-Financial Index and the ICE BofA BB Euro High Yield Index as at April 2022.

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Emergence from the pandemic

- As a large part of the world reverts to something approaching 'normality' following the pandemic, the focus of attention has pivoted from reopening to growth. Business investment and demand for credit have remained strong despite the uncertain macroeconomic and political backdrop.

- Nevertheless, the recovery is still vulnerable to further virus mutations and a corresponding reduction in demand. Some areas might never fully recover to the pre-pandemic levels of activity, for example, international business travel.

- China continues to be an outlier with its zero-tolerance COVID-19 policy. This is expected to have a negative impact on the nascent supply chain recovery (and thus inflationary pressures) and on global economic growth this year. In the longer term, this disruption has the potential to increase onshoring, which could stimulate further investment opportunities in private markets, such as demand for industrial real estate and supply chain financing.

ESG and impact investing

- We expect to see an acceleration in the transition to renewable energy in Europe driven by the Ukraine conflict. The UK government has already announced its intention to ramp up offshore wind and hydrogen production in its latest energy strategy.[2] The EU presented its REPowerEU Plan recently which unveiled measures to phase out dependency on Russian gas and oil through energy savings, diversification of energy supplies and an accelerated roll-out of renewables.[3]

- Given the level of investment required, private capital is likely to play a key role in the area of accelerating renewable energy roll-out.

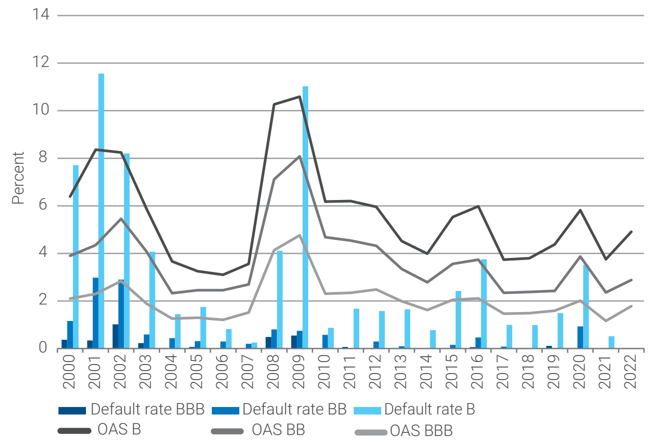
- Sustainability-linked loans have come to the fore this year with more issuers willing to include sustainability key performance indicators (KPIs) in their debt packages. We see this as a positive development and an opportunity for private credit investors to engage and influence borrowers. LGIM is working proactively with borrowers to ensure that the sustainability KPIs go above and beyond 'business as usual' and the progress reporting framework clearly demonstrates where genuine impact has been achieved. In some cases, we have looked to encourage more ambitious target setting from the borrower by linking the yield on their debt to those KPIs.

Looking ahead to the second half

It is difficult to predict where we go from here. The key question is whether monetary policy is going to be aggressive enough to engineer a 'soft landing' – taming inflation without inflicting too much pain on economic growth. The market has not yet felt the full impact of quantitative tightening and further reductions in central bank purchases could introduce more volatility to the credit market. At the same time, there is the potential for downside risk to interest rates and inflation should a recession lead to a dovish pivot from central banks.

Given the extent of rate rises already priced in and concerns around growth, we believe investor focus is likely to switch from duration risk to credit risk. Although defaults may stay low, slowing growth and tighter financial conditions could weigh on performance for less resilient assets. Public market performance over the last 20 years suggests that during times of market stress, investment-grade (represented by BBB bonds), crossover (BB) and high-yield (B) bonds have tended to experience a broadly similar level of spread widening, but BBB- and BB-rated bonds have suffered far lower defaults than B-rated bonds.

Figure 3. Credit default rates: where next?



Source: Bloomberg and S&P "2021 Annual Global Corporate Default and Rating Transition Study". The 2022 option adjusted spread (OAS) is as at end May 2022.

In such an environment, the strength we witnessed in private credit in the first half of the year will continue to be tested. We advocate maintaining high credit quality and robust risk management which will help weather any storm. As a result, we have a bias to defensive issuers. While remaining cautious, volatility can present an opportunity to add exposure to quality assets at attractive prices, which, we believe, will help investors achieve stronger long-term returns.

2. Source: [Government unveils investment for energy technologies of the future - GOV.UK (www.gov.uk)](www.gov.uk) as at April 2022.
3. Source: REPowerEU: A plan to rapidly reduce dependence on Russian fossil fuels and fast forward the green transition, May 2022.

Contact us

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