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Waiting for the storm: private credit outlook

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Executive summary:

- The private credit market has generally been resilient this year. The investment-grade and crossover space has seen decent deal flow, pricing discipline, strong premium and not forgetting a higher yield environment. Tighter credit conditions and bank retrenchment are likely to accelerate the shift towards private market financing, in our view.

- Our central expectation is for restrictive monetary policy to stay in place until inflation is brought under control, potentially resulting in a coordinated recession in the US and Europe.

- Credit risk will become a more dominant performance driver, in our view, and the macroeconomic environment favours higher-quality assets.

- Higher rates have boosted the performance of short-dated assets but, we believe, have also enhanced the attractiveness of longer-dated assets, particularly for liability matching or income-driven investors.

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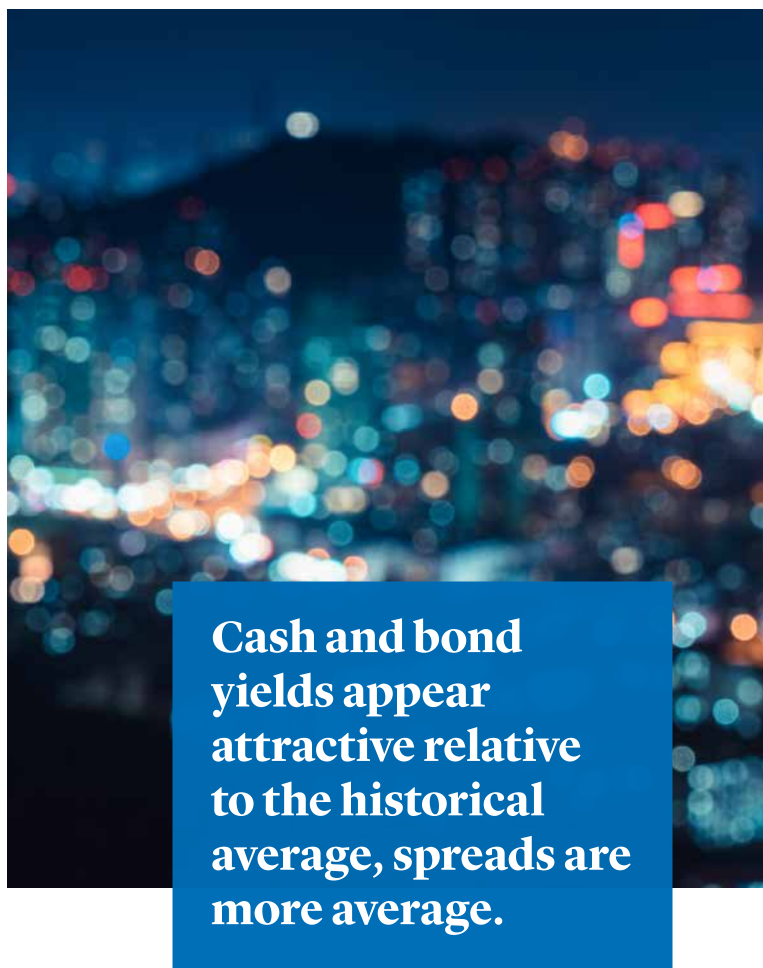
2023 so far - the calm before the storm

1 Yields remain high

- Driven by higher rates, yields remained elevated, with US cash and US 10-year Treasury yields in the 95th and 85th percentiles, respectively, compared with their 20-year averages[1].
- Investment-grade private credit is currently yielding at c.5-7% and crossover (BB rated) at c.8-9%[2], also much higher than the historical average.
- Sterling and dollar investment-grade public credit spreads are now below their long-term averages, while euro credit spreads are still hovering above their long-term averages, which may represent a potential buying opportunity. High yield spreads, in comparison, look less attractive when you consider the heightened recession risk.
- Understandably, most borrowers are not keen to lock in current rates for a long period and prefer to issue shorter-term debt.



Cash and bond yields appear attractive relative to the historical average, spreads are more average.

Asset class	Yield	Average over 20 years	Percentile
$ Cash	5.1	1.5	98%
£ Cash	4.9	1.7	96%
€ Cash	3.4	0.9	97%
10-yr UST	3.8	2.9	84%
10-yr Gilts	4.4	2.7	87%
10-yr Bunds	2.4	1.9	65%
$IG Credit	5.5	4.1	85%
£IG Credit	6.5	4.3	85%
€IG Credit	4.4	2.7	80%
$HY Credit	8.6	7.9	60%
€HY Credit	8.0	6.9	60%

Credit spreads (OAS)	Risk premia value	Average over 20 years	Percentile
$IG Credit	1.2	1.5	38%
£IG Credit	1.5	1.7	41%
€IG Credit	1.5	1.4	56%
$HY Credit	3.8	5.0	31%
€HY Credit	4.5	5.0	44%

Source: Bloomberg, LGIM analysis as at 08 August 2023.

The value of any investment and any income taken from it is not guaranteed and can go down as well as up, and investors may get back less than the amount originally invested.

1. Source: Bloomberg as at August 2023.
2. Source: Bloomberg as at August 2023.

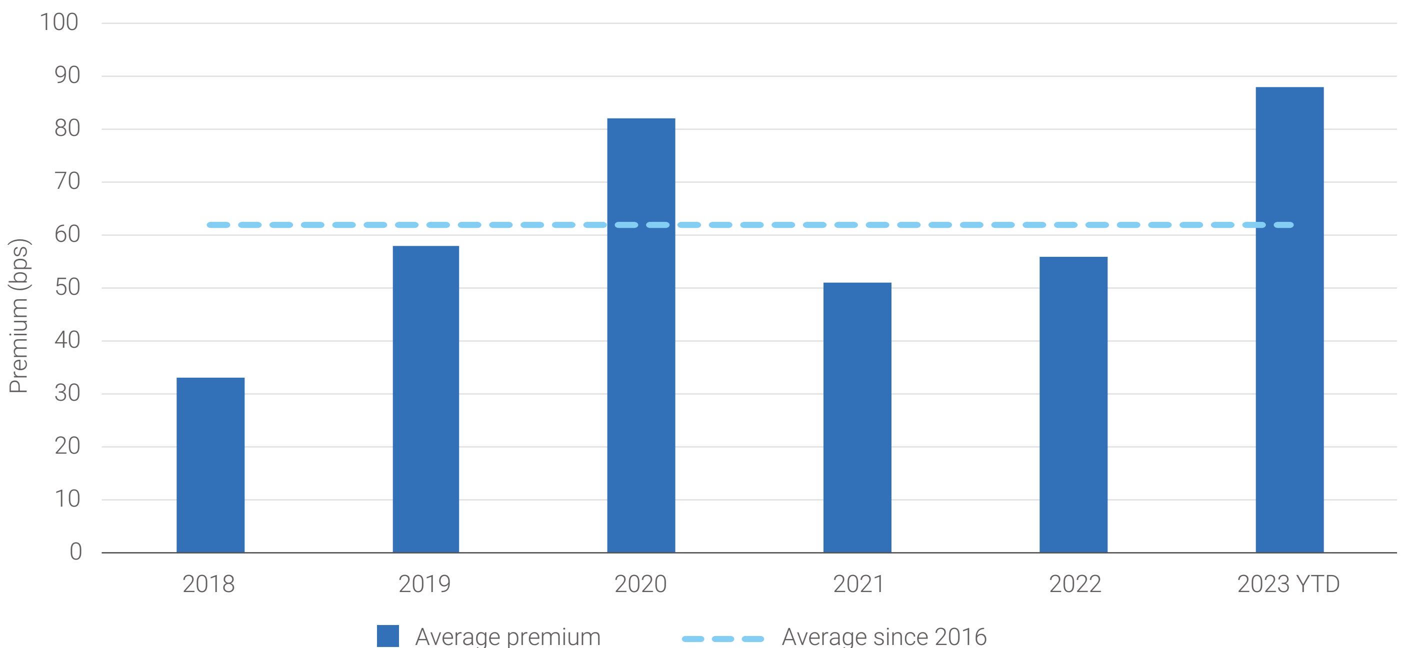
2 Busy market, helped by bank retrenchment

- Market volatility in 2022 drove borrowers to the more stable private credit market[3]. This accelerated again in 2023 as the banking crisis and tightening credit conditions caused borrowers to reduce reliance on banks and the public market.
- Within the corporate debt space, we saw a broad sector mix of European corporate issuers. In the US, corporate issuance was dominated by energy infrastructure and utilities[4] which are more cost agnostic (they can pass through the debt cost increase to the consumers under the regulatory regime).
- Not everyone is tapping into the market. Some borrowers such as housing associations are reliant on low-cost, long-term debt and have been very quiet this year. REITs, which make up a big chunk of the US corporate debt market, have also been quiet following weakening sentiment regarding commercial real estate.

3 Greater divergence, more investor-friendly dynamics

- Investors are increasingly cautious and selective. Appetite for high-quality assets is still strong but overall investors have been less aggressive on price. Premium versus public bond comparables have generally been higher than average this year[5].
- This growing divergence between defensive issuers and weaker, more cyclical issuers, has resulted in the latter needing to offer better terms to attract interest.
- This is somewhat different from the public bond market, where spread dispersion across sectors is low within investment grade (with the exception of financials vs non-financials).

Investment-grade private credit premium versus comparable public bonds has been higher than average in 2023



Source: LGIM Real Assets, based on client portfolio as at August 2023.

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3. Source: Market evidence suggests that private credit transactions in 2022 and 2023 have not fallen in the same way that the public credit market did.
4. Source: Based on market observations.
5. Source: LGIM Real Assets as at June 2023.

Real estate debt: pressures and potential opportunities

The commercial real estate (CRE) market has experienced a significant market correction, starting with the UK in H2 2022, and the US has been playing catch up in 2023. The crisis in US regional banks, which have significant exposures to CRE loans, added more pressure to the sector.

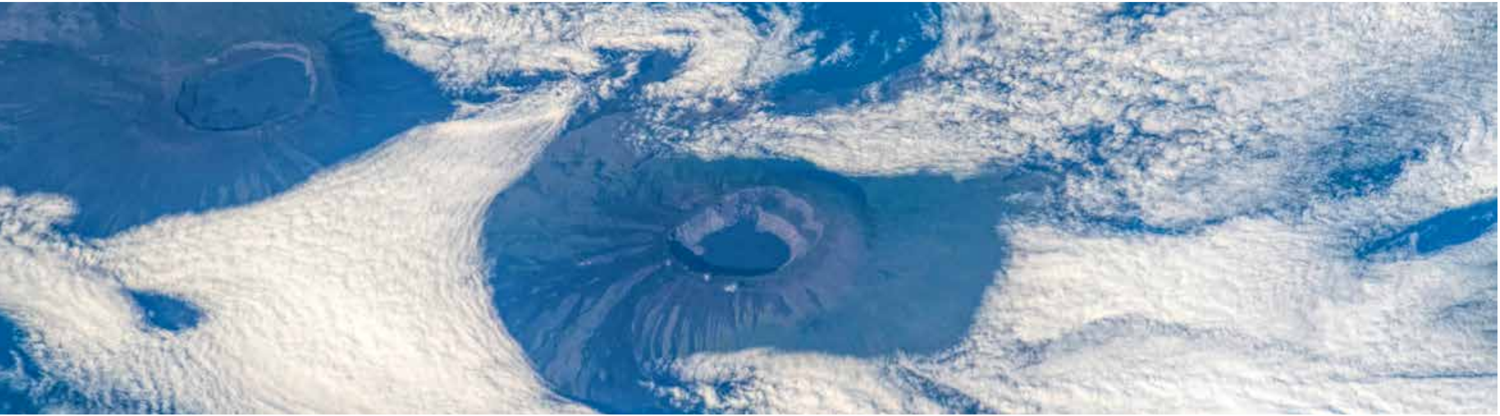
The biggest challenge facing CRE loans is the cost of refinancing, which has increased substantially since the start of 2022 (up by c.75-100% in the US and UK[6]). So far, we have seen borrowers and lenders actively working together to get through this challenging period. Borrowers have generally been willing to inject capital in order to protect equity, and lenders are amenable to amend-and-extend loans where possible.

We do not expect another period akin to that of the Global Financial Crisis (GFC), mainly due to much lower leverage in CRE loans after the GFC (typical loan-to-value fell from an average of 80% pre-2008 to today's 60% for senior debt). We believe there will be, however, cases where a resolution cannot be found, particularly with US smaller banks, where deposit flight has put more pressure on liquidity. This could lead to an increase in defaults and forced sales.

However, the current environment has, we believe, presented a window for investors to step in and provide financing on attractive terms. The real estate debt market has been busy in 2023. We have seen a strong volume of high-quality assets in resilient sectors such as residential and industrials where investors were able to benefit from higher yields, lower loan-to-value (50-55% instead of 60%)[7] and less bank competition.

That said, the prospect of weaker economic conditions over the next 12-18 months requires a careful approach to assessing cashflow risk for the assets' underlying real estate loans, as well as a focus on capital expenditure requirements, including those associated with ESG / energy reduction initiatives, in our view.

6. Source: Green Street, Bayes Business School, LGIM, as at June 2023.
7. Source: Based on market observations as at June 2023.



Spotlight on: introduction to debt for nature transactions

How does it work?	These transactions involve a highly rated third party (AAA to A rated) underwriting the credit risk of the borrower (typically a developing country). An example is the $1.6bn Ecuador debt-for-nature swap in May 2023. This is an emerging area in private credit with only a handful of precedents so far. However, recent transactions have attracted strong investor demand and performed well. As such a number of other countries are considering similar transactions. Maturities range between 5 and 20 years. Typically, they are fixed rate loans denominated in US dollars or euros.
Rationale	• Borrower: by "wrapping" the transaction with insurance, default risk is transferred to the insurer, which significantly reduces the cost of debt and broadens the pool of potential investors. • Investor: Richer premium versus private credit transactions of similar credit rating due to the niche and complex nature and an opportunity to support developing countries.
Potential attractions	As part of the transaction, the borrowing country is required to spend a portion of the debt cost saving on projects that deliver positive environmental or social impact. This essentially enables investors to fund crucial conservation efforts in the borrowing country. There have also been similar transactions funding essential infrastructure developments. Examples include marine and forest conservation, construction of new schools and transport infrastructure. Progress is monitored by independent charities / auditors against agreed milestones and penalties imposed if the milestones are missed.
Key risks	Default risk[8] Geopolitical risk Reputational risk

8. Although default risk is minimised by the insurance, in the case of default the claim can still take months depending on transaction structure.

Waiting for the storm

LGIM's central macroeconomic view remains a synchronised recession in the next few months across US and Europe. As inflation continues to be persistent, central banks are expected to maintain a hawkish monetary policy and are unlikely to offer much support in a recession until inflation is back to target. The combination of higher rates and weaker growth is expected to keep financing conditions tight.

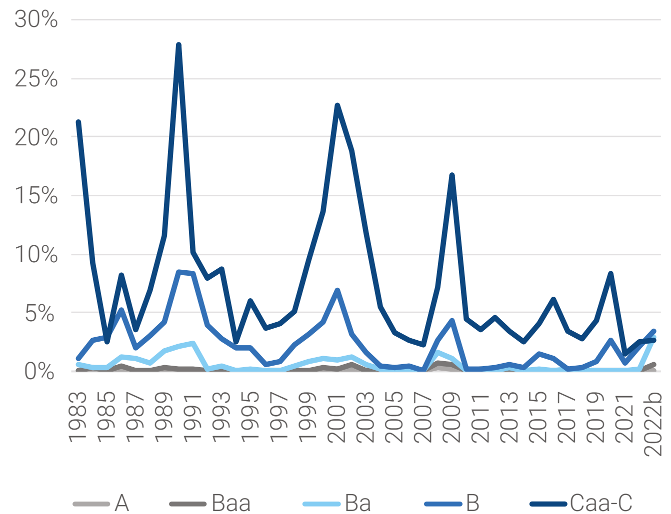
Markets, on the other hand, are looking through the downside risk. Public equity valuations and credit spreads do not appear to have priced in a recession. This is at odds with central banks' fight against inflation. Unless we have a soft landing further rates/spreads volatility later this year seems likely, in our view.

How will private credit fare in this environment over the rest of 2023?

We expect the market to remain busy, as borrowers continue to seek alternative sources of funding in the face of refinancing needs, tighter bank lending and public market volatility. A deep recession could significantly drag on deal flow, although any monetary policy easing could increase transaction volume.

Credit risk will become a more dominant driver as investors renew their focus on fundamentals, so asset selection will be critical. The macro environment favours investment-grade over high-yield private credit, given the latter's smaller size, weaker fundamentals and rate sensitivity. Historical bond market data suggest that credit loss is likely to spike during times of stress for single B or lower rated assets, but loss rates should be low in the investment-grade and BB space.

Annual credit loss by rating



Source: Moody's Annual Default Study, April 2023.

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Investment-grade private credit has demonstrated its resilience over several economic cycles. High-yield private credit (which includes direct lending) has a more limited track record as the asset class grew significantly in benign market conditions after the global financial crisis. The floating rate nature has supported its return in this cycle so far, but headwinds from restrictive rates, weaker earnings and higher costs will put pressure on lower-quality borrowers, in our view. Performance will depend on the ability to cope with financial stress, but a rise in defaults and losses is likely, in our view.

We note that high-yield private credit is offering a significantly higher headline return which may appeal to investors willing to tolerate higher potential losses. New senior debt issuance is currently yielding at 10-13% with spreads at around 600-800bp[9].

Given the macro uncertainty, our approach continues to be to stay up-in-quality. This implies a current preference for investment-grade and crossover private credit over high-yield, and defensive issuers over cyclical. As we approach the end of the hiking cycle, we believe duration looks more attractive and we will continue to seek opportunities to lock in long-term fixed-rate assets.

9. Source: SPP Capital, Cliffwater as at June 2023.

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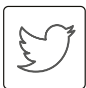

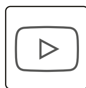

Key risks

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