POSITIONING FOR THE TURNING OF THE CREDIT-CYCLE

By Marc de Kloe en Ruud Smets

With the COVID-19 pandemic hitting credit markets that were already vulnerable, we expect a large global distressed credit cycle to unfold.

BUILD UP TO TODAY

The current market environment that we find ourselves in today is, in certain ways, reminiscent of our experiences in the credit markets leading up to and during the Global Financial Crisis (GFC).

The main difference is that, in the run up to the GFC, consumers and especially banks were overleveraged. This time around, it is the corporate credit market that is looking fragile. Corporate credit markets have more than doubled since the GFC and BBB's representing more than 45% of the investment grade market, could overwhelm the high yield market, should some of these be downgraded.

Nevertheless, with extremely low interest rates and continuing Central Bank intervention, the party looked set to continue with very little distress on the horizon. There were, however, certain risks in the asset management space where more than 25% of high yield bonds were held by liquid vehicles, while 80% of the underlying assets did not trade on a daily basis. Due to regulations, bank/dealer inventory had come down to a fraction of where it used to be (less than 10%), which opened up the space to sudden liquidity shocks, as there were very few players able to absorb market flows.

THEN THE MARKET TURNED

At the end of March 2020, we experienced a ferocious sell-off in terms of speed and size never seen before in credit markets. Over $ 200 billion was pulled out of daily liquid vehicles, holding structured credit instruments, leaving a near vacuum in the space. With banks not in a position to play a significant role in absorbing this volume, this left only specialist credit traders as the buyer of last resort at significant price discounts.

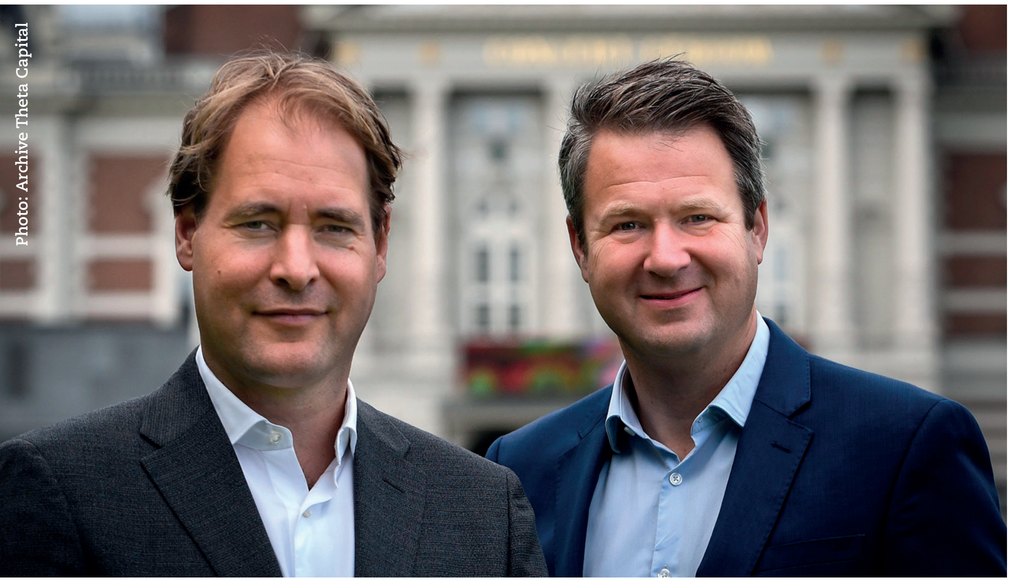

Photo: Archive Theta Capital

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THE SURPRISE OF THE MARKET SELL-OFF

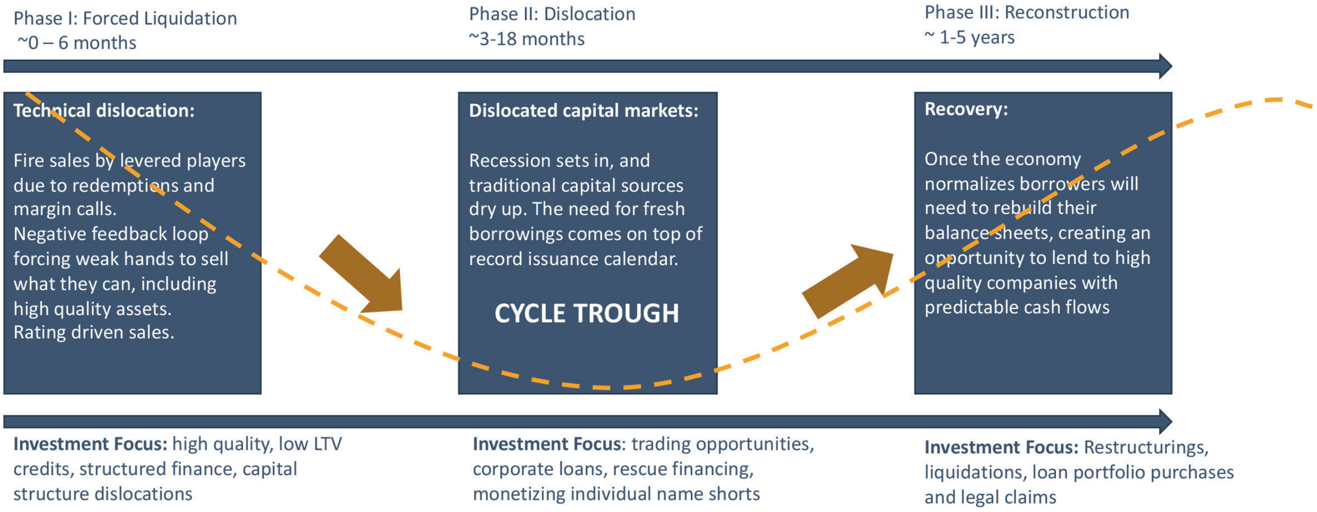
No crisis plays out exactly as you expect it to! The space that was considered mostly insulated from a downturn (the US consumer due to low LTVs on their housing, strong employment numbers, wage growth, improvements in FICO scores et cetera), had initiated a sell-off in the structured credit markets due to the liquidity mismatch.

The amounts that funds needed to sell, overwhelmed the market and the funds were forced to sell at very low dollar prices (in some cases over the weekend!), in order to be able to make payments to their investors the next day. This sudden drop in prices led to a cascade of further mark-downs and forced selling in the structured credit markets without much discern for asset quality.

Most distressed cycles start with a technical liquidity crunch, where good assets are sold by forced sellers. This was exactly what happened in March, allowing managers with cash at hand to buy good assets at distressed prices.

- **Phase 1:**
  In the structured consumer credit market, prices have recovered from their lows. However, prices have not recovered as much yet and there are still pockets of high quality assets to be bought, as there has been a lot less intervention in the market and there are only a limited number of natural

Figure 1: Anticipating a multi-year, multi-phase cycle: Anatomy of a distressed cycle



Source: Theta Capital Management, 2020

buyers of the asset class, meaning there are still opportunities. We expect a good recovery given the high levels of collateral, as well as structural credit enhancement, in addition to the forbearance programs in place.

There are also areas of the structured credit space where investors need to be far more discerning, especially in the Collateralised Loan (CLO) and commercial mortgages (CMBS) space, where we see analogies to the big short trade experienced during the GFC. We see short term opportunities for shorting these areas and eventually longer term going long.

- **Phase 2&3:**
After the forced liquidation phase, which allows liquidity providers to buy high quality assets at fire-sale prices, we expect a phase of dislocated capital markets before we enter the road to reconstruction. Given the ferocious speed of this crisis, we have also already entered the start of the dislocation phase. Throughout the first half of the year, nearly 70 companies have defaulted or led distressed transactions, affecting over $ 100 billion of debt. The year 2020 now ranks as the second highest annual default rate on record, trailing only 2009. Within a few months, default rates have risen to their highest level in a decade, to 6.6%. Nearly every industry and economy has been impacted.

Short-term cash needs will come on top of an already historically large issuance calendar of companies, municipalities and governments that need to refinance. As the scale of financing needs dries up traditional capital sources, large trading opportunities will emerge, as well as the opportunity to provide rescue financings at attractive terms for those that have cash at hand. As downgrades and defaults quickly pick up, this is also when individual credit shorts start paying off. There will be a myriad of companies and other issuers who will need to restructure, and others who will need to liquidate. In this phase the focus will be on complex debt restructurings and liquidations, with attractive returns driven by process risk rather than general market moves.

OUTLOOK AND FUTURE POSITIONING – BE PATIENT

There is still plenty to be worried about: a second coronavirus wave, the outlook for SME's decimated by the economic fall-out, a highly volatile November US election looming, with many unknown and market-moving outcomes, and continued tensions with China. The market's recovery has been more fragile than it appears, led by a few pandemic 'winners', while many companies are struggling, even though Central Bank intervention has kept capital markets largely functioning.

We do believe it is certain that default rates will continue to remain elevated, with the outlook for certain industries worse than others. With high default rates, we expect there to be multitudes of restructurings ahead.

We are still in the early innings of this cycle. Disciplined corporate distressed debt specialists, that manage their own internal capital in the first place, remain patient and in many cases have so far stayed closed to new capital.

We believe the focus today should be on the structured credit markets and particularly on the consumer segment, which can offer double digit returns, backed by strong fundamentals and collateral. Going forward the opportunities on the corporate side will grow, as will the opportunities in sovereign and municipal/provincial debt. Investors should therefore not get distracted by equity market returns and remain patient, capitalizing on this highly attractive opportunity set in credit markets; the best we've seen since 2009. «

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