RBC Global Asset Management

Stress before distress

Opportunities in the European mid-market

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Entering 2024, central banks have seemingly pulled off the unthinkable, an immaculate rate hiking cycle that has left global growth supported, interest rates higher and jobs largely intact. It's a little early to call victory and the end of the story, however, it is clear the much lauded 'once in a generation' default cycle is not quite what people expected.

So, where does this put the outlook for stress and defaults, particularly within the European mid-market space and why should it matter to investors?

In this paper, we look at the forces affecting speculative grade lending including:

- **The evolution of the market**
- **The current borrowing environment**
- **Macro headwinds**
- **The timely opportunity set this offers to investors**

The birth of an asset class

Leveraged finance, or speculative grade borrowing, is an asset class that has seen rapid expansion over the last two decades. Defined as bonds rated BB+ or lower, and encompassing high yield(HY), leveraged loans and private credit, the market has grown a startling 960%, from $0.5tn in December 2000 to $5.3tn in June 2023.

“This evolution is important as it changes the nature of how you look at quality and risk within leveraged finance.”

Looking at the chart below it has not always been evenly distributed. In the years following the global financial crisis (GFC), many issuers chose floating rate instruments such as loans and private lending, given the overall lower cost of coupon payments.As a result, there was a fast expansion in these areas.

Another post-GFC phenomenon was new bank regulation that penalised banks for lending directly to riskier capital structures, causing banks to focus instead on engaging with larger businesses through their public debt offerings in the HY bond market.

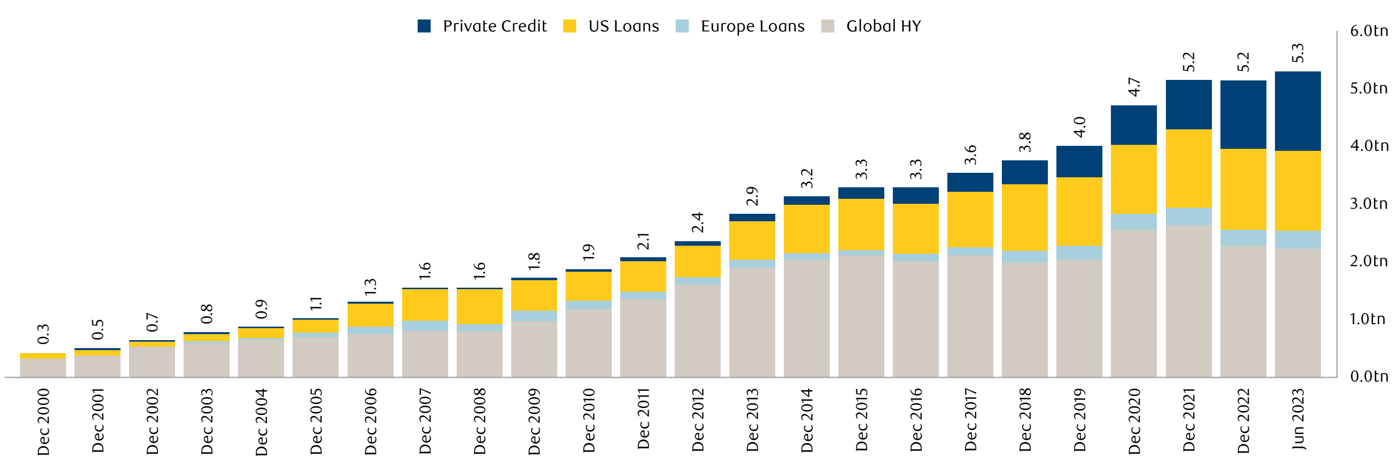
This left a gap in capital support for small to mid-sized businesses. Stepping in to fill this void was private credit, and the collateralised loan obligation (CLO) market.

The former originate loans with locked up capital on a one-to-one basis; and the latter engage the syndicated loan market, buying bonds and structuring tranches to create a waterfall of risk for different rewarded investors.

Both provided capital to meet the growing demand of issuers taking advantage of low and falling rates, stable growth and benign inflation. This also provided an avenue for smaller private businesses with lower credit ratings - typically these tended to be within the lower, single B and CCC space (or rating equivalent). At the same time, the percentage of issuers within this cohort fell within traditional HY markets, raising the overall quality of those indices.

This evolution is important as it changes the nature of how you look at quality and risk within leveraged finance. Today spreads in HY are at generational tights which seems at odds with where we are in the rate hiking cycle. Default rates are expected to range between 4-6%, which gives a false perspective of where stress is likely to emerge. In loans this is predicted to be as high as 9%; in private credit the data is harder to source, but it is likely to be in line or higher.

Figure 1: Leverage finance assets under management (USD tn)



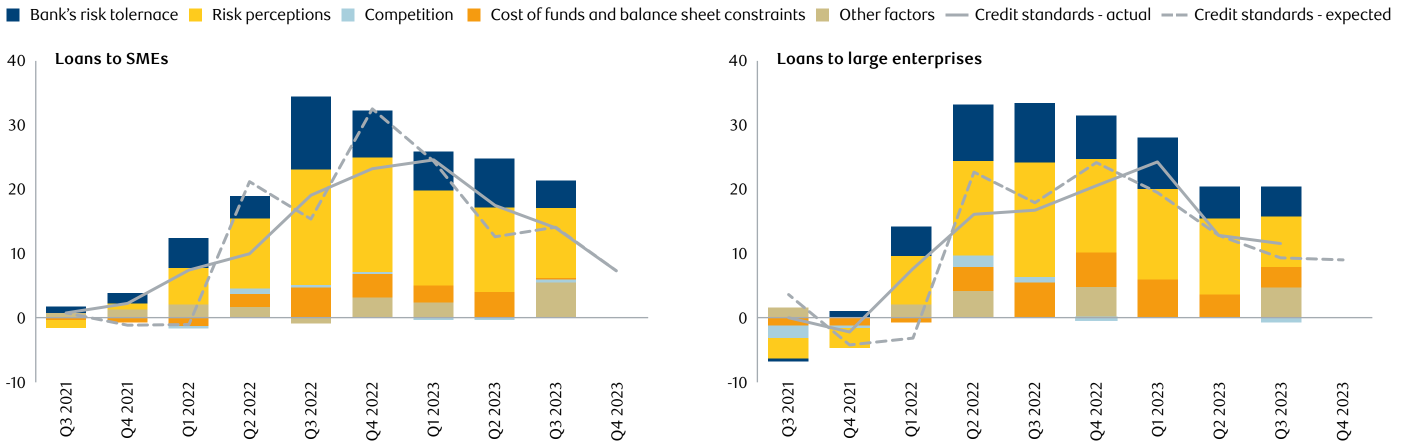
Source: Private credit – Preqin (drawn/deployed capital); Global HY – Ice BAML; US and European Loans - LCD, as at July 2023.

The current borrowing environment

To get a sense of the environment for businesses' ability to borrow, we can look to two data points. The cost of borrowing, and the credit standards being applied by financial institutions. Large, solvent, cashflow rich businesses have access to markets, but others with more challenged business models are likely to find punitive rates, or restrictive covenants applied.

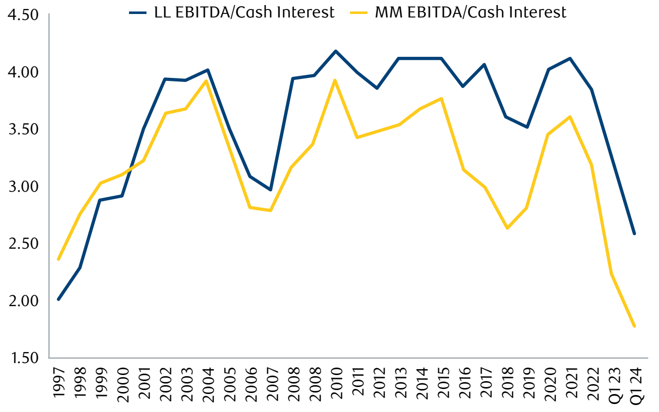
In loans and private debt, interest coverage has fallen dramatically as a direct result of increased borrowing costs meaning the ability for companies to service their debt going forward has dramatically declined. Issuance in both loans and HY has been reduced over the last two years. In 2024, we expect borrowers to come back to markets meaningfully, as existing debt matures, and they look for new financing.

Figure 2: Changes in credit standards applied to the approval of loans or credit lines to SMEs and large enterprises, and contributing factors



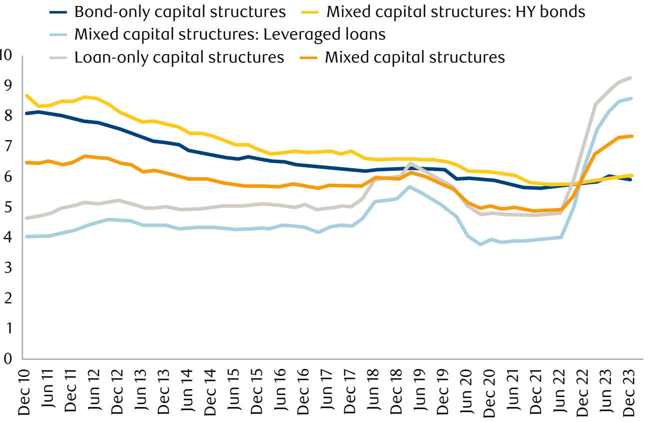
Source: ECB Bank lending survey (BLS), as at July 2023.

Figure 3: Collapse in direct lending interest cover ratios



Source: Pitchbook LCD, middle market loans used as representative of direct lending loans, as at January 2024.

Figure 4: Average coupon payment in US Lev Fin Market



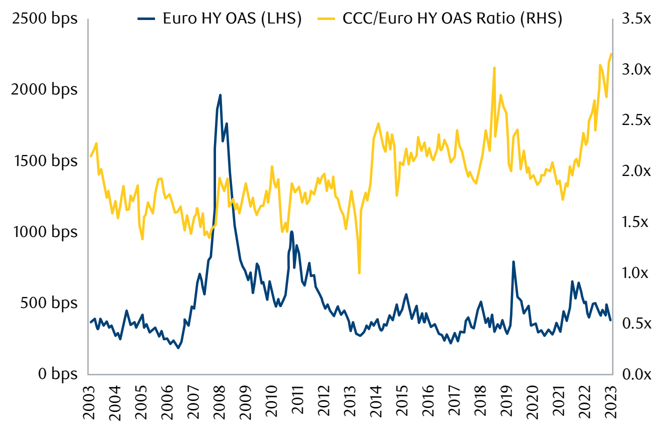
Source: Bloomberg, Morningstar LCD, Goldman Sachs Global Investment Research, as at January 2024.

While the cost of borrowing has fallen recently in HY markets, on the back of expectations rates will be cut, it remains elevated for floating rate debt, which will only drop again once rates actually fall.

> **"Businesses that have stronger business models and revenues are likely to see a flock of demand."**

Either way, the test for companies will be how markets react to further calls of capital. Businesses that have stronger business models and revenues are likely to see a flock of demand. Where there is transparency in the Euro HY market, we can see that CCC is now trading at a 20 year high in its ratio to the broader index. To put this another way, weak borrowers are having to pay more than three times the amount than the rest of the market.

Figure 5: Ratio of CCC spreads to Euro HY index



Source: Bloomberg, as at December 2023.

Macro headwinds

Outside of higher rates, we see three major factors impacting borrowers:

- Higher core inflation including continued wage pressure
- Changing global trade and demand
- Fiscal tightening

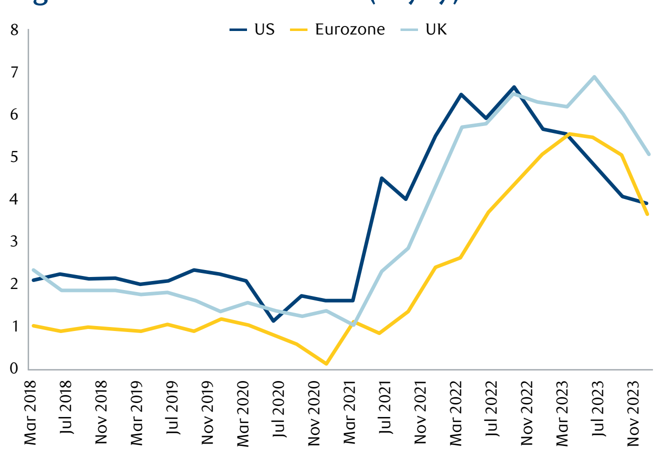
Following the dovish pivot by the Fed and cooling headline inflation globally throughout Q4 last year, expectations of future interest rate probabilities across the US, UK and Eurozone are now pricing in over 100bps of cuts: implying a harder landing than current economic data would suggest. Off the back of these expected rate cuts, risk assets and yields have rallied hard suggesting risks are skewed more towards the downside.

While economic data in the US may imply a soft landing, it is too early to tell. The effect of a rate shock has yet to be seen in markets. Inflation has cooled, not driven by a cooling in demand, but a relief to supply pressures effecting core goods, and cooling commodity prices including deflationary effects from falling oil prices.

> **"The lag is not only long, but it is also variable; that is, the time between cause and effect can differ from episode to episode in a way that is difficult to predict."**
> **Milton Friedman**

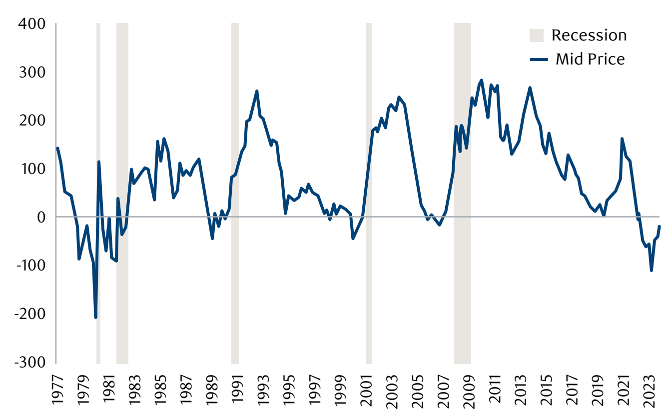
US jobs data and growth continue to deliver strong prints. While jobs data remains strong, both wage pressure and consumer confidence are likely to support a picture of sustained inflation.

Figure 6: Core CPI Inflation (% yoy)



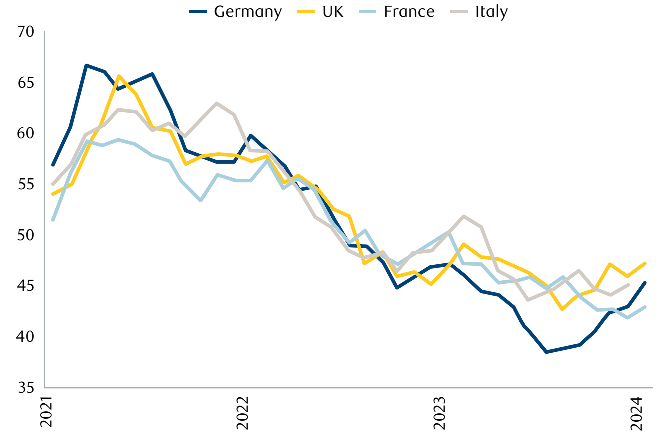
Source: Fitch Ratings, SBLS, Eurostat, ONS, Haver Analytics, as at November 2023.

Figure 7: US recessions typically occur after the yield curve steepens or uninverts



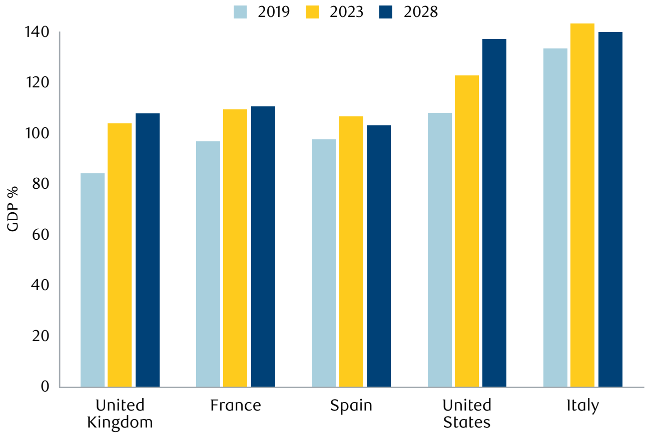
Source: GFD, Bloomberg Finance LP, Deutsche Bank, as at January 2024.

Figure 8: Eurozone PMI manufacturing



Source: Fitch Ratings, S&P Global HCOB, Haver Analytics, as at November 2024.

Figure 9: Government dept to GDP expected to rise



Source: Fitch Ratings, as at January 2024.

Rates are now likely to be on their way down, but the speed of these cuts, and their terminal rate are up for debate. Two impacts of higher rates going forward are that a recession, especially within Europe is still likely, and in the US it's too early to know if one has been avoided. The role of predictors of recessions is an inexact science, but it's important to note that with the commonly used 2s10s inverted yield curve, recessions have typically only occurred once rates have peaked and usually only once inversion has reversed.

The other challenges global trade and demand, and quantitative tightening are likely to further impact businesses. In Europe, the slowdown in China has impacted economic activity. Weak PMIs in major economies, such as Germany show signs of weakening demand. Within global trade, and more broadly, supply shocks and protectionism are fuelling desires to shorten supply routes.

The difficulties with shipping in the Red Sea, are just another example of how unexpected external shocks can put pressure on production. This is even before you look at how higher resultant shipping costs will lead to further inflation pressure, providing a headwind against some of the declines we have seen in core goods.

> **"In Europe, the slowdown in China has impacted economic activity."**

The final piece of the puzzle is country balance sheets. Currently economies, such as the UK and US are seeing deficits more aligned with war time budgets, debt-to-GDP of most developed nations has been growing, and eventually pressure will be seen in the cost of financing this borrowing. Pressure on fiscal balances will limit the ability of governments to provide stimulant fiscal policy for declining sectors and trade related weakness.

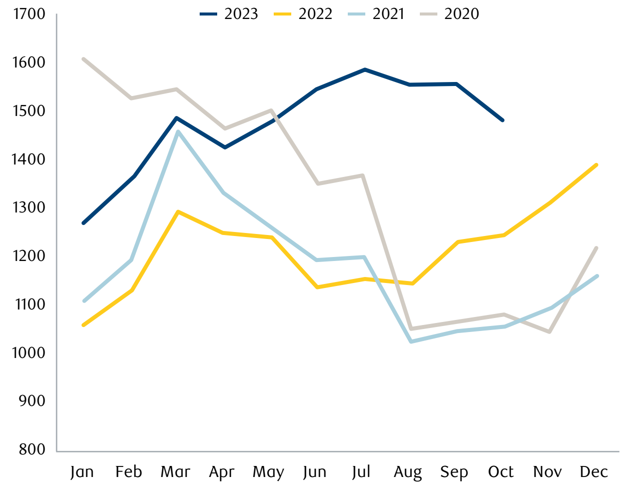
What does this mean for investors?

The challenge for borrowers is going to be concentrated within small-to-medium-sized businesses. The rapid expansion of borrowing over a period of benign economic stress has led to a large cohort of borrowers that are now facing significant pressure.

This includes economic factors such as lower growth, higher inflation, higher rates, and disruptions to trade and foreign demand, to more direct impacts such as increased borrowing costs, stricter lending, and changing investor demand. Our expectation is that the largest capital structures should weather this storm well, but smaller businesses will likely be the most exposed. Data on European bankruptcies already makes for sober reading.

Today, as we look at risk assets and forward pricing for rates, the market is priced to perfection and the risks are now skewed to the downside. Investors would do well to consider strategies that can help hedge portfolios, or even drive returns, in a deeper recessionary environment.

Figure 10: Insolvencies in Germany have risen to new highs



Source: Halle Insititute for Economic Research. Excludes companies that are not registered, as at December 2023.

Author

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Adam joined BlueBay Asset Management (which is now part of RBC Global Asset Management) in October 2020 as Head of BlueBay Special Situations within Developed Markets. Adam has 30 years' experience in special situations and distressed investing having previously been Head of Investments at Blantyre Capital, European CIO of Marathon Asset Management and Head of European High Yield & Distressed at Lehman Brothers. Prior to that, Adam was Head of the Asian Distressed team at Standard Bank and he started his career at British & Commonwealth Merchant Bank in structured and property finance. Adam holds an MPhil in Land Economy from Cambridge University and BA in Economics from Heriot-Watt University.

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