Press Release

Credit Market Update: Relocating the Dislocation

David Allen, Managing Partner and Chief Investment Officer, AlbaCore Capital Group

London 21 September 2022 - The first half of 2022 was the worst in recorded history for high yield credit markets, with US and European high yield posting returns between -14% and -15%. Taken in isolation, this would have been the second worst calendar year in high yield performance, trailing only the global financial crisis. However, in July, all of that appears to have changed for the time being. Equities, high yield and loans (but not investment grade) have recouped much of May and June's negative performance in both the US and Europe.

A (largely technical) market rally

We largely attribute recent market performance to technical factors and residual market fatigue from what has been a tough year on the back of a very good year for most investors. Primary issuance volumes and fund flows play a key role in the technical aspects of the recent rally. Following a drought in primary issuance (both European and US high yield issuance volumes are down over 70% compared to 2021 according to JP Morgan), and steady outflows from high yield funds and ETFs through July (US and European funds/ETFs seeing ~10% and ~12% estimated outflows respectively), the combination of nothing on offer, with no cash to spend, kept markets shut and prices flat to down.

We have seen some recent momentum in US high yield flows (~+4% in August with Europe positive but lagging), which has meant fund managers have cash to spend with no primary issuance to spend it on. As a result, we have seen higher quality and liquid names stage a rally in July and August.

Sometimes a period of flat-to-positive performance is all you need to arrest and reverse an extended period of negative performance, but we are not reading too much into the recent market rally. We have taken a cautious approach and now anticipate a recessionary environment in coming quarters, driven by factors like margin pressure, higher rates, and quantitative tightening.

What other trends are notable in current credit markets?

The influence of higher rates is currently paramount, and foreign currency fluctuations are heavily influenced by rate moves and expectations. This can create temporary distortions in individual credits, or similarly situated pockets of risk. For example, rates, the forward curve, and underlying investor sentiment sometimes coincide such that the same underlying credit risk price varies based simply on what currency the security is issued in.

In today's market it is worth noting the trends in both EUR and GBP spreads relative to USD, as GBP spreads today are near historically wide levels, which could allow for some very attractive opportunities to present themselves.

Perspective on company earnings, inflation, and rates

Given the substantial market moves and reactions, we have been very focused on certain macro factors the past few quarters. Dispersion and a decoupling of the US and UK/European markets seems likely to be a big theme in the coming quarters as each economic area grapples with its own economic woes.

Company Earnings – Largely we are seeing demand holding up well, with reported revenue, order book and backlog numbers largely coming in strong, but we are still seeing margin pressure. While many companies have been able to pass through price increases in the past few quarters, there is an element of catch-up at play here. Commodity prices have largely stabilized or decreased in recent months, and we are heading into quarters where comps should be easier against 2021's inflation spikes.

Inflation – The US recently showed signs of a slight relenting on inflation, driven primarily by lower gasoline prices. The US is better equipped to handle inflation with a more diverse economy and more resilient energy sector than the UK and Europe. Still, while energy prices have come down from 2022's peaks, significant risks remain in Europe and the UK particularly where a record-breaking summer heatwave has complicated energy redundancy options across the continent. Russia has shown a willingness to press its advantage in energy markets to Europe's detriment, and those risks escalate as winter approaches.

Rates – We believe it is wishful thinking to plan for rates to come back down in 2023. We are factoring this into our models and underwriting.

Through the first half of 2022 markets have certainly kept us busy. During this period our efforts to refine and improve our processes across the firm have continued, and we look forward to seeing what the rest of the year will hold.

David Allen is the Managing Partner and Chief Investment Officer at AlbaCore Capital Group.

Mr. Allen has nearly 30 years of financial services and investment experience, with a focus on the High Yield and Leveraged Finance Markets.

Prior to founding AlbaCore Capital Group, Mr. Allen managed Canada Pension Plan Investment Board's European Principal Credit Fund and was a member of the Investment Committee. Mr. Allen was also a Partner, Investment Committee member and Senior Portfolio Manager at GoldenTree Asset Management, where he established and ran the firm's European presence. Mr. Allen spent a decade with Morgan Stanley in New York and Hong Kong, working across M&A and investment banking before specializing as a High Yield media analyst.

Mr. Allen graduated from the University of California, Berkeley, where he earned a Bachelor of Arts in Economics and was an all-conference rower.

About AlbaCore Capital Group

AlbaCore Capital Group is one of Europe's leading specialist credit investors focusing on public and private corporate credit markets. The senior investment team have been investing with this hybrid strategy for over a decade. Founded in 2016, AlbaCore has invested over ~$23bn [1] for global pension funds, sovereign wealth funds, consultants, insurance companies, family offices and endowments.

AlbaCore is focused on consistently outperforming the market in the long term while protecting investor capital. The credit selection process is based on fundamental research with a focus on capital preservation, ESG factors and risk-adjusted returns.

Headquartered in London with offices in New York and Dublin, AlbaCore has a partnership approach with values at the center of the AlbaCore community.

www.AlbaCoreCapitalGroup.com

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[1] Invested capital is the sum of all 'buy' trades for all AlbaCore mandates since inception to 30 June 2022, and includes recycled capital and co-investment.