Press Release

Credit Market Update: Interest Rate Volatility Returns as Markets Adjust to 'Higher for Longer'

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

London 25 October 2023 – Over the past few months, European leveraged finance markets have continued to see strong returns, and while defaults remain low at the moment, there are some signs that higher interest rates are beginning to impact industrial performance.

The transition from the previous low-rate environment to one where rates may be higher for longer will continue to have significant implications for both consumers and corporations. While consumers continue to demonstrate surprising resilience, **it's clear that there is growing weakness in the manufacturing sector across Europe**. PMIs have dipped into negative territory in several European jurisdictions, and the effects of slower Chinese growth and rising energy prices appear to be weighing on countries with a more manufacturing-centric focus[1].

This industrial weakness is apparent in corporate performance, with 'destocking' – reducing inventory – being a common phrase in recent earnings reports from many European corporates we follow. However, this has not translated into a widespread wave of defaults. European leveraged loan defaults stood at 1.27% as of the end of September for the prior year period. While this represents an increase from their 2022 lows, defaults remain below their long-term averages[2]. Distressed ratios, defined as loans trading below a price of 80, have markedly improved from this time last year, dropping from 6.73% to 2.21%[3].

In contrast to the US high yield market, where triple-Cs have seen nearly 250 bps of spread tightening this year, similarly rated European bonds have drifted wider, with an average option-adjusted spread of over 1600 bps as of the end of September[4]. The weaker macroeconomic environment in Europe has contributed to this, but the lack of appetite for triple-C risk has been compounded by weak recoveries from unsecured bonds this year in Europe.

There are signs that M&A activity, although still currently low, will pick up in 2024.

In August 2023, markets began to signal the end of the interest rate hikes. At that time, inflation was declining across Europe and the US, and it seemed that this had been achieved without plunging economies into recession. However, as market participants returned from the summer break, this

[1] Source: Deutsche Bank "Cycle Dashboard: Rising divergence and what it means" 19 September 2023.
[2] Source: LCD Morningstar European Leveraged Loan Index LTM Par Weighted Default Rate as of 30 September 2023.
[3] Source: LCD Morningstar European Leveraged Loan index as of 30 September 2023.
[4] Source: ICE BofA CCC & Lower European Currency High Yield Index and ICE BofA CCC & Lower US High Yield Index as of 30 September 2023.

euphoria faded. With oil prices increasing by 28.5% in September[5], fears have grown that inflation may increase yet again. While the market is not currently pricing in any further hikes by the ECB, the mantra that rates will be higher for longer has taken root. Government yields have risen once more, and interest rate volatility has dominated market headlines, with US ten-year yields reaching levels not seen since before the Global Financial Crisis.

Historically global interest rates have been around the 4-5% region, **suggesting that the low-rate environment of recent years is the anomaly and interest rate hikes represent a return to more normalised levels**.

Strong technicals continue to drive returns

More broadly, European leveraged finance markets continue to demonstrate their resiliency despite the interest rate volatility. European high yield bonds returned 1.88% in the quarter, outperforming their US counterparts (+0.46%) and global investment grade (-3.59%). Modest spread tightening and coupon income have helped to offset rising yields[6]. **In a world where interest rates are expected to stay higher for longer, investors are shifting their focus to higher coupon instruments,** and the sterling high yield bond market has clearly benefited from this trend. After only seeing £1.1 billion of issuance through to the end of August, September witnessed a flurry of activity, including a couple of much anticipated issuances.

Contrary to many market participants' pessimistic expectations at the beginning of the year, the European loan market continues to outperform its fixed rate counterparts. Loans hit a 16-month high on the 25 September 2023, with average loan prices peaking at 96.69.[7] The ongoing strength of the loan market is driven by a combination of robust demand for paper from ramping CLOs and the generous coupon income the asset class now pays. However, the market does exhibit some signs of fragility. **If the current rate volatility leads to a broader risk-off sentiment, it is crucial to be prepared to take advantage of this dislocation. We are closely monitoring good quality, liquid names that could potentially sell off**.

Credit markets are eagerly awaiting M&A activity

The resilience of the European loan market and strong demand in primary indicates that credit markets are constructive. This is a notable change from a year ago when the UK LDI crisis and concerns about potential winter gas shortages across Europe caused spreads to widen to over 860 bps in October 2022. The question, however, is when new issuance, currently at its slowest level in a decade, will increase.

[5] Source: West Texas Intermediate (WTI) as of 30 September 2023
[6] Source: Bloomberg Barclays Pan-European High Yield Index, Bloomberg Barclays US High Yield Index, Bloomberg Barclays Global Aggregate Index as of 30 September 2023.
[7] Source: LCD Morningstar European Leveraged Loan Index as of 30 September 2023.

There are signs that M&A activity is beginning to pick up. Given the ever-growing volume of private equity dry powder and increasing pressure on sponsors to realise investments, if market conditions remain supportive, we expect activity to accelerate in 2024.

Sponsors have a range of options when it comes to financing transactions today, and we are increasingly observing instances where deals are being dual-processed, with sponsors simultaneously considering both syndicated and private financing solutions. Private equity sponsors are willing to pay a premium in private credit markets for transactions that are more time-intensive, bespoke, or where certainty of execution is key. For sponsors, the appeal of private credit market largely lies in the ability to build long-term symbiotic relationships with lenders who provide quick feedback, even if it is negative, and offer certainty of execution.

The case for positioning higher in the capital structure

As European banks continue to play a reduced role in European lending markets, lacking the appetite to underwrite risk or engage in complex deals such as carve-outs or public-to-private transactions, we believe there is a structural role for lenders to play. **Senior private loans to large-cap issuers look particularly attractive in this environment.** The higher interest rate environment means that these loans offer the potential for high single-digits returns, a notable increase from just a few years ago. When factoring in the benefits of sitting at the top of the capital structure and the fact that the higher interest rate environment is leading to lower leverage, we believe senior loans offer compelling risk adjusted returns.

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

Mr. Allen has more than 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 alternative credit specialists, investing in private capital solutions, opportunistic and dislocated credit, CLOs, and structured products. Founded in 2016,

AlbaCore's investment philosophy is focused on capital preservation and generating attractive risk adjusted returns through the cycle for its investors. AlbaCore manages US$ 9.8 billion in assets as of 30 June 2023 on behalf of global pension funds, sovereign wealth funds, consultants, insurance companies, family offices and endowments around the world.

For more information, visit www.AlbaCoreCapitalGroup.com