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Private Credit vs. Public Debt (First of a Series)

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One of the more discussed charts we've run in this newsletter recently compared direct lending yields with that of high-yield bonds. Seems as if many were surprised at the significant spread differential between the two asset classes. For those who missed this chart, we reprise it below as our *Chart of the Week*.

It made us wonder how many of our readers would benefit from a review of the distinctions between private and public debt, and between middle market loans and their broadly syndicated counterparts. With that in mind, we begin a series exploring the backdrop today for credit investors seeking yield and relative safety.

There are a plethora of factors to consider when comparing different investment strategies. Yield is just one of them. Others include interest rate risk, credit risk, liquidity, volatility relative to market moves, security, and duration risk.

Let's begin with interest rates. The vast majority of active fund managers have operated in a rate environment that's been almost entirely bond-friendly. Hard to imagine, but in April 1980 (three months before your correspondent launched his banking career), the prime rate hit 20%. Eighteen months later, 30-year Treasuries reached a high of 14.7%. Today those rates stand at 3.75% and 3.02%, respectively.

Will the next thirty years mirror the post-1980 period, with rates rising back to double-digits, or will structural changes in our economy, as well as nationalist trends globally, dampen growth and rates for years to come?

Regardless, it's doubtful that fixed income instruments will benefit from the same headwinds they've enjoyed since the Carter Administration. That's one of the reasons institutional investors have jumped into floating rate assets, particularly as the Fed seems to be moving towards a more hawkish tone on rate hikes.

Another element influencing loan vs. bond decisions is where we are in the business cycle. The Trump trade may have pushed a potential recession off a bit further, but it also may have raised the height from which the economy could eventually fall. That worry has motivated funds who seek more safety at the top of the capital stack. Leverage loans, as we know, are secured by the assets of the issuer, while bonds are unsecured and in a subordinated position.

Default rates across loans and bonds have eased as energy-related issuers have either restructured or healed with last year's uptick of oil prices. But experienced accounts know that losses incurred by unsecured bondholders tend to be higher than for secured loanholders. The only question is when a downturn will begin.

That's why, amid the multitude of unknowns investors face over the next several years, it's helpful to focus on the known characteristics of private and public credit alternatives.

Next week we continue our loan vs. bond series by looking closer at relative yields.