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“The Best Place to Be” (Second of a Series)

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As a long-term observer of (and participant in) the credit markets, we’ve learned the most interesting times are not when things are going swimmingly for issuers or investors. Life becomes intriguing at the inflection points, when established trends begin to shift.

These moments are often apparent only in hindsight. The Great Recession, for example, ended in June, 2009 – barely six months after the rescue of General Motors and Chrysler. Yet it wasn’t officially announced (by the Business Cycle Dating Committee of the National Bureau of Economic Research) until September 20, 2010.

Predicting change can also be tricky. Calls that the end of the cycle is near have been numerous, and wrong. Trouble is that over the past several years, signals of a downturn, like an inverted yield curve, have turned out to be premature.

Tied closely to economic fortune is the direction of interest rates. Both cause and effect of business prospects, rates were headed sharply up last year. That is until the market’s surprise tanking in November led the Fed to hit the brakes and reverse course.

Everyone then expected continued easing, but the startling improvement of 3Q corporate earnings pushed the Dow, NASDAQ and S&P 500 to record heights. Some say the likelihood of further cuts next year has diminished to one or even none.

All this has altered once again the conversation about private credit risk. Instead of being on the edge of a downturn, with all the trimmings, it seems as if another year’s reprieve has been granted. What, then, should the consequences be for private credit?

There are three. First, being a floating-rate asset class, middle market loans are inherently hedged to rate movements. High-yield bond funds attracted cash when rates fell. That move has slowed. Second, while terms and structures have weakened, sustained economic growth lifts all issuers. Lastly, a reprieve doesn’t mean a reversal. We just have more time to get our credit ship in shape.

To that end, experienced firms have been closely monitoring their exposure to cyclicals. By definition, those are borrowers whose prospects are tied more tightly to the economy. Any concentration more than 25% of capital should be a concern.

It’s also time to think about dedicated workout teams. No coincidence that credit managers, prompted as well by investors, are trolling for experienced restructuring professionals. Expertise that went untapped for years is now in high demand.

Being alert for inflection points doesn’t mean you’ll recognize one. Nor should credit managers change strategies with every Treasury move or ISM data blip. All-weather risk management means applying consistent credit standards no matter the cycle.

But being aware of subtle changes to market technicals resulting in spread widening or leverage tightening can benefit your investors. Until the next inflection point.