High Yield Bonds and Private Credit (First of Two Parts)

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In our just-completed series on high-yield bonds [link], we conclude that issuer and investor activity has largely been driven by technical factors: near-zero interest rates, the Fed's support of fallen angels, and skewed-to-worse ratings for leveraged loans.

If this is the environment in the liquid market, how should investors be thinking of the illiquid market, i.e. private credit?

By contrast, as followers of this commentary know, private credit follows a very different path to that of tradable assets. Fundraising has occurred in earnest around the notion that providing investors with steady income (and issuers with long-term credit solutions), regardless of market volatility, is a major benefit.

As our *Chart of the Week* shows, middle market senior secured loans demonstrate higher yields over time than other asset classes. And that data does not include 2020. Post-COVID spreads should widen relative to recent performance, thanks to economic uncertainty.

Structurally, direct loans remain a more sound credit investment than junk bonds. Senior, secured, with financial covenants – these loan features lead to better recoveries and lower losses.

We saw as well that bond fund managers, thanks to Fed support, are loading up on COVID-sensitive businesses such as cruise ships, hotels, and retailers. Over time, though, these sectors struggle through cycles. Active private credit managers know that playing defensively in (selectively) healthcare, IT, software, and business services allows for more stable portfolio performance in a downturn.

There's also the tradeability factor. The bond investor, like the liquid loan buyer, takes comfort from an active secondary market. If you worry credit performance is heading south, you can theoretically sell your exposure readily. Assuming you're not in a period like March when all prices cratered.

Private credit managers care less about market timing than issuer fundamentals. The 2020-2021 vintage could prove to be the best in over a decade, but leading direct lenders have been actively putting money to work through the cycle. Jumping in and out of the market, as "fast money" is doing in high-yield funds, tends to be counter-productive for illiquid assets.

It's tough to scale a credible origination platform over the long haul without a consistent deal sourcing strategy. Private credit tends to be more relational, less transactional. New deal flow depends on building long-term confidence with private equity firms. Sponsors certainly try to access public markets when conditions warrant. But when markets back up, they swing right back to their friendly, flexible direct lenders.

? Next week: How do high-yield and private credit assets behave in volatile times?