2020: A Year of Surprises (Part Two)

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We continue our special series with the second of our "Five Biggest Private Capital Surprises of 2020:"

Surprise #2: Non-Correlated Trends – Infections, Markets, and the Economy

The Global Biological Crisis of 2020 was different from the Global Financial Crisis of 2008 in several ways. Of course, one started with a virus, the other with home mortgages. Also, commercial activity wasn't shut down as quickly twelve years ago, nor was its recovery as swift. Finally, there wasn't the sharp "have/have-not" distinction among industries as there has been today.

But at moments in both crises when financial markets felt the brunt of investor pessimism, asset prices reacted similarly. Across public equities and credit, for example, valuations swooned in synch as investors found no safe havens amid the cataclysms. Bad news sunk everything. In that respect, to paraphrase Tolstoy, happy markets were happy in different ways; unhappy markets were alike.

As our *Chart of the Week* highlights, cumulative correlation among liquid loans, high-yield bonds, and stocks rose dramatically after the Great Recession; less so during the pandemic. Yet it's clear that tradeable assets were increasingly correlated over the past twenty years. Investors have taken note of this trend, hence the growing popularity of illiquid credit.

The current downturn began as the last one did, though more precipitously. With the world's population sheltering in place, all commercial activity would be affected. The question was, how?

As the second quarter wore on and COVID spread, some businesses shut down. The have-nots were more affected, while the haves even benefited from the crisis. Capital flowed into the latter, and out of the former. (With the exception of junk bonds, where the "Powell put" distorted that market.)

Because the downturn was infection-driven, protective measures were viewed as having a salutary economic impact. Public equities, reflecting future expectations, detached from the spread of the illness. This was evident as the third COVID wave swelled and the Dow reached record highs.

In the meantime, when the pandemic unfolded, private capital managers attended to their portfolios. For buy-and-hold investors of non-traded, middle market assets, the health of existing credits was paramount. If there's no ready secondary market to off-load troubled loans, the best you can do is work with private equity owners to get through tough times.

A combination of supplying sufficient liquidity from revolving credits, and covenant adjustments to ease borrowers' financial burdens, made for much smoother sailing than anticipated. Rather than facing a raft of quarter-end defaults, direct lenders focused on keeping businesses chugging along and generating a robust new deal pipeline.

Next week: Surprise #3: Where Are All the Distressed Loans?