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Private Credit in an Age of Scarcity (First of a Series)

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Our keynote address at this week's SuperReturn US Private Credit conference allowed us to share a reconsideration of the impact of rate hikes and quantitative tightening on capital markets and private credit. This special series will further develop that thesis.

For over a decade, including through Covid, the tide of capital has flowed mostly in one direction: into markets. That's because since the Great Recession the Fed has kept interest rates low. Public credit, both loans and bonds, benefited from this support.

Private capital, particularly credit, has also enjoyed a one-way stream. With interest rates low, investors sought higher yielding investments while still retaining low risk. Private equity sponsors obliged by working closely with their relationship direct lenders to put their own LP money to work with a burgeoning pipeline of buyout financings.

From a credit perspective, structures and pricing became increasingly issuer-friendly as arrangers competed for lead deals. These erosions were rationalized because elevated purchase price multiples provided greater cash equity cushions below the debt.

Covid threatened to upend this momentum, but the Fed's loose money intervention quickly restored it. That liquidity rescue combined with continued supply chain challenges created unusual upward pressures on inflation, resulting in headline CPI levels not seen in decades.

The persistence of high consumer prices, as illustrated by August's worse-than-expected 8.3% report, has forced the Fed into more hawkish messaging. Investors have translated this to greater recession and default risk. Loan funds have responded by jettisoning $20 billion since May accompanied by $12 billion departing bond funds in the past three weeks, per S&P/Lipper.

Thanks to QT, liquidity is also retreating from the banking system. Bank reserves are projected to be drawn down from $3 trillion to $2 trillion. Some bankers say they have been told to restrict their corporate and wholesale lending.

We've reported for years how the BSL market is being disintermediated by the largest direct lenders. But as SOFR soars from near zero a year ago to nearly 4% projected by year end, those lenders are seeing shrinking interest coverage ratios on highly leveraged deals.

Naturally this is all sobering news. Some seasoned credit investors are on the sidelines, waiting for more direction from markets and the economy. Our reappraisal of current conditions, however, suggests there may be a lot for investors to cheer about, particularly in private credit.

Over the the next several weeks, we’ll examine why capital scarcity is ultimately beneficial for illiquid loans. We’ll also discuss other attendant issues such as capital velocity, hold levels and periods, and default risk.