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The New Paradigm (Last of a Series)

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In the capital markets this year, it's all been about rates and inflation: can the Fed's higher-for-longer regime bring prices down close to pre-pandemic levels without triggering a recession? At the moment, the answer seems to be yes.

Both credit investors and issuers are using private capital as a vehicle proven resilient through rate, economic, inflation, geopolitical and biological cycles. The success of the asset class has highlighted its unique characteristics, also creating questions from observers less familiar with illiquid credit dynamics.

Last week we reported on a conversation with Van Hesser, chief strategist for KBRA. Mr. Hesser joined us for our latest *Private Capital Call* podcast. Following up on our questions about credit defaults, we asked about the economic outlook, given earlier more pessimistic forecasts.

The 2023 economy has evolved differently than expected, Hesser told us. "We had the suspicion in the back half of 2022: yes, we are slowing. The Fed is not going to be our friend through this. But the strong starting point of consumers and businesses gave us a sense that this might not be a traditional recession.

"Think about how the default environment has played out over the last eight years: the energy washout back in 2015-16, the retail apocalypse, and Covid. We had some rolling mini-default cycles. What's left is reasonably battle-tested. That point us to a significantly lower default rate than we've witnessed in the past.

"This won't be a typical recession. It may be stall speed over the next couple of quarters with sub-trend growth. But that's very different than a recession with financial instability and a lot of uncertainty. We know inflation is the problem. The visibility around that has been relatively clear. We think this "downturn" will be more manageable than what we've seen in the past.

"Looking ahead to next year, we're moving back to normal. We haven't been to normal in fifteen years! After the GFC there was massive QE around the world, zero percent interest rates engineered by central banks. Now we're looking at a "normal" cost of capital. Achieving an acceptable rate of return is not going to be as easy as it was.

"Someone once told me that in a zero interest rate environment, borrower and lender intelligence goes down. We're coming out of that. You need a business model to withstand the environment and an appropriate capital structure that can absorb normal rates, slower growth, and technological disruption. You also have higher costs related to energy transition, or security of everything.

"These will present significant headwinds, which is back to normal," Hesser concluded. "But it will feel very different than what we've gone through in the last fifteen years."