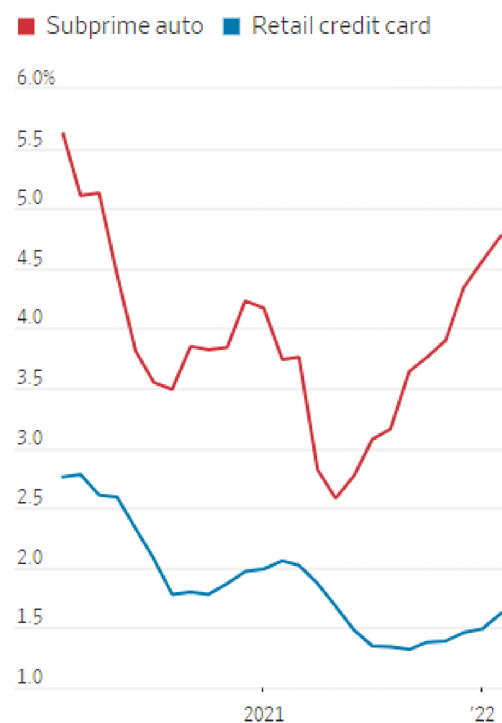
PUBLIC CREDIT

Credit markets saw a mostly weaker quarter as high yield bonds returned -4.15% and leveraged loans were flat. High yield bond yields finished March at 6.3%, up 160 basis points from December, while spreads finished at 400 basis points, up 70 basis points from December.

In a sign that interest rate hikes have largely driven performance, higher rated bonds with higher duration have underperformed (10-year treasuries -6.6%, IG -7.7%, HY Muni's -6.5%, BB's -4.9%, and CCC's -4.3%). However, the collapse in issuance for riskier bonds also points to some investor concern around credit quality. In Q1, high yield issuance fell 70% to $47 billion (from $160 billion in Q1 2021), while investment grade issuance rose. From a sector perspective, commodities-related companies performed the best, while consumer-oriented companies lagged. Energy returned -1.9%, Metals/Mining -2.4%, Media -2.6%, and Gaming -3.4%, while Housing -6.3%, Retail -6.1%, Food/Bev -6%, Consumer Prod -5.8%, and Autos -5.7%. Structured credit posted losses as well, but with a broad range. RMBS performed the best (-1%) given the continued strength in residential housing, followed by ABS (-2.9%), MBS (-5%), and CMBS (-5.6%).

The quarter also saw a welcomed pickup in dispersion following a post-Covid environment of tightening spreads and higher correlations both within and across asset classes. The most glaring example has been commodity-related businesses. Those that sell commodities have benefited significantly – at least those that haven't been fully hedged – while companies with high commodity-sensitive input costs, such as tire producers, have seen margins decline.



Source: WSJ

We will be watching for signs of income statement deterioration as a leading indicator of balance sheet impairment. As earnings season continues, we're likely to see a widening gap in earnings strength between companies with relatively elastic and inelastic demand. As consumers feel the pinch of higher prices and a lack of further fiscal stimulus, demand will likely fall for non-essential purchases. Historically, auto loans have been a good indicator of consumer health, given these are seen as a 'last-to-default' loan due to the necessity of mobility for work, groceries, healthcare, etc. Perhaps that has changed over time given car-sharing services, grocery delivery, telemedicine, etc., but we think it still warrants a close watch. While auto delinquencies remain below pre-pandemic levels, they are on a worrying (and sharp) upward trend, as shown in the chart here.

Given how much debt has been refinanced within the high yield and loan markets over the past two years, we're nowhere near a maturity-wall induced distressed cycle, and balance sheets remain healthy. Trailing 12-month default rates are approximately 50 basis points, and bank credit desks see a jump to only 1.25% in 2023. But with the severity of inflation, rising rates, supply chain disruptions, and a lack of fiscal stimulus impacting consumer behavior as well as a collapse in investor demand for risky new issuance (high yield issuance was down 70% year-over-year in Q1) the stage could be set for a meaningful distressed cycle late next year.

Outside the US, there has been significant volatility in emerging market debt stemming from the war in Ukraine. One of the next big questions looming over the economic war against Russia is what will happen to its bonds. The Russian government has borrowed about $49 billion in the form of dollar- and euro-denominated bonds, over half of which is owned by foreign investors. The majority of defaults occur when the bond issuer has run out of cash. In this case, Russia has the willingness and ability to pay its debt. It collects the equivalent of over $1 billion a day from its oil and gas deliveries alone, and while most of those funds are being spent on the war, it could still earmark capital towards servicing its debt payments.

A Russian default would stem from the inability to process the payments due to limited access to dollars after the US blocked the country from using its reserves held at American banks. Russia has until May 5th to make about $650 million in dollar-denominated debt payments, but with no clear ability to do so, Russia may be on the cusp of its first default on its foreign debt since the Bolsheviks ousted Czar Nicholas II over a century ago (the 1998 Russian debt crisis was only a domestic debt default). According to Oxford Economics, the impending Russian debt default is likely to be one of the most difficult in history to resolve and could even lead the US to permanently seize assets from the country's central bank.

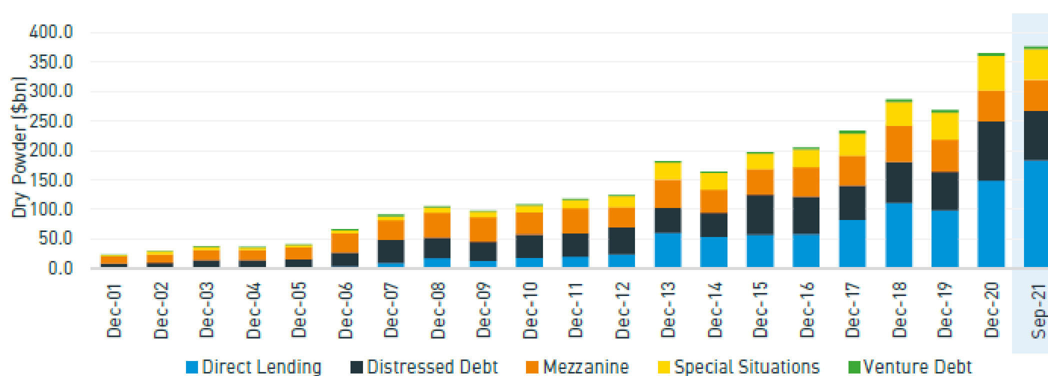
The significant uncertainty on the fate of Russia's debt hasn't deterred investors from trading in its bonds. In fact, the volume of trading in Russian debt has risen to a two-year high, with MarketAxess data showing that Russian sovereign debt traded at a volume of $7 billion between February 24th and April 7th, up from $5 billion in the same period in 2021 – a 35% uptick. The rise in trading volume is primarily driven from selling of traditional EM bond funds to non-traditional holders, including some of the largest distressed credit investors who have begun aggressively scooping up debt as prices have fallen. In fact, some of these investors have been able to set-up a negative-basis trade in which they have purchased Russian government or corporate bonds along with Russian credit-default swaps (CDS), which act as insurance on the potential default of a borrower. As traditional investors look to quickly rid their portfolios of anything Russia-related, bond prices have fallen faster than the price to hedge them have risen.

In general, distressed credit investors have been more focused more on corporate bonds than sovereign bonds, eying companies that can generate dollar- or euro-based cash flows outside of Russia as it may be easier to remit those hard currency funds back to foreign investors, partially because the money may never need to be routed through Russia and possibly trapped by sanctions.

After seeing its resilience tested as never before during two years of pandemic-related disruptions, the private credit market is poised for growth as yield-hungry institutional investors extend their hunt for high-performing assets. Covid-related lockdowns in 2020 dealt a series of blows to borrowers, pushing default rates higher and creating new debt repayment challenges to both private and public companies. However, global central bank stimulus programs limited the damage and helped private debt withstand the effects of the downturn. US private loan default rates peaked at 8.1% in the second quarter of 2020 before falling back to 1% in the fourth quarter of last year, according to the Proskauer Private Credit Default Index.

A large number of US public pension funds have increased their allocation to private debt as they look for ways to increase investment returns. Two of the largest US public pension plans – CalPERS and CalSTRS – both stepped up their private credit allocation last year with a 5% target allocation. Most of these flows are expected to be directed towards sponsored direct lending, given the ability to commit a significant amount of capital especially to the mega-sized firms. GPs have responded to the increased demand by raising $193.4 billion in aggregate in 2021, with over 60% directed towards direct lending strategies. According to Preqin, this has resulted in private credit assets swelling to over $1.2 trillion, a 17% increase over 2020. As a result, as depicted below, dry powder in the asset class has grown with direct lending strategies representing over $200 billion.

Dry Powder by Private Credit Sub-Strategy



Source: 2022 Preqin Global Private Debt Report

The 10 largest private credit GPs have increased their market share of private credit assets; in 2021, their share accounted for 42% of all capital. This development contrasts with the picture in private equity and real estate, where the top 10 funds have attracted an average of 27% and 30% of LP capital, respectively, over the past 10 years. The only caveat, however, is that these asset classes also tend to have many more funds in the market than private credit.

The first quarter was a mixed one for private credit as credit markets remained resilient and defaults were benign. Investors that were overweight to income-oriented strategies generated strong returns, as performance continued to be driven by coupon payments. Distressed related strategies were flat to slightly lower, driven by mark to market valuation declines in specific distressed and post-reorg equity positions.

As we look forward, given the significant amount of capital flowing into sponsored based lending strategies, we remain steadfast on avoiding the space and have focused more on non-sponsored opportunities with a focus on the lower US middle market, given it remains highly fragmented, and GPs with strong sourcing network can still find opportunities to underwrite loans to high quality borrowers with strong economics and tight covenants. Outside of corporate lending, we have also focused on other income-oriented strategies, including specific areas of specialty finance and asset-based lending where yields remain relatively healthy and there is strong collateral value supporting the underlying loans. For example, areas of focus are loans backed by commercial real estate assets or working capital assets such as accounts receivables or inventory.

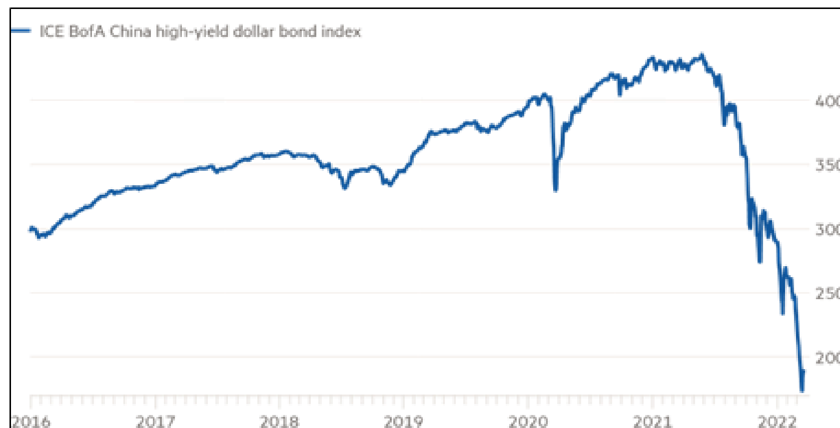
One area that we have become cautious is taking on consumer credit risk especially in the subprime space, given the possibility of higher delinquencies if rising inflation and slowing growth persists. In fact, buyers of bonds backed by subprime car loans or credit cards are demanding the highest premiums over interest-rate benchmarks since mid-2020.

Turning to distressed related investments, we believe the opportunity set is more attractive in Europe and Asia. In Europe, governments have generally pulled back on Covid-related support. Although some may increase spending to cushion the impact of the Ukraine-Russia conflict and resulting sanctions, fiscal relief is unlikely to fully offset the fall-out of the war, potentially creating special situation opportunities focused on the smaller and mid-sized companies that will continue to face challenges accessing traditional financing channels.

CONTINUED VOLATILITY IN THE CHINESE PROPERTY MARKET

As we have discussed in prior letters, the primary opportunity in Asia is in China's property sector debt market. Much of developed credit markets have, so far, remained relatively immune to the heightened geopolitical and inflation risks; however, the quarter did bring continued volatility to the Chinese high yield market and more specifically to the property developers that continued to face challenges in making debt payments. Investor risk aversion was heightened due to recent defaults in the sector. In 2021, China high yield property bonds suffered their worst calendar year loss on record with the default rate reaching around 30%. As shown below, the stress continued in the first quarter with Chinese single-B spreads now trading as wide as 6,500 basis points over Treasuries, reflecting the stress in the property sector.

Chinese High Yield Index Performance



Source: Bloomberg

Further adding fuel to the fire, international audit firms have begun resigning from China's property developers as a wave of delayed financial results has increased uncertainty over the total amount of leverage in the system and potential existence of hidden debt. PwC, which audits more than a dozen listed Chinese developers, is under investigation in Hong Kong over its Evergrande audit, and it and Deloitte have resigned as auditors of at least five Chinese developers in the past three months.

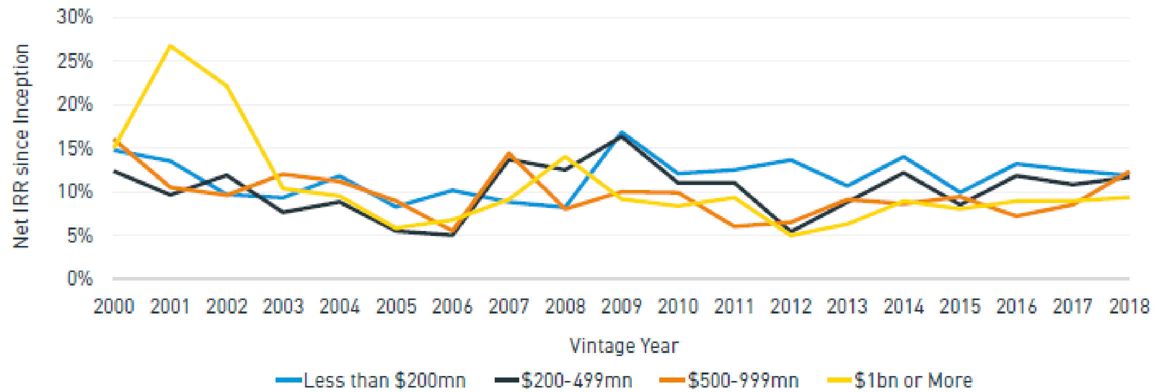
Regulators have begun to realize the challenges and impact on overall growth and have started to initiate policies for stabilizing both physical demand and financial markets. In December 2021, the Central Economic Work Conference confirmed a policy shift for the New Year recognizing the near-term downward pressure on the economy resulting from weak investment in property and infrastructure and emphasizing stability as the top policy priority for 2022. In the first quarter, there have been some green shoots that the physical market is improving. For example, in January, there was a decent rebound in property sales in Tier 1 cities and this trend spread into Tier 2 cities in March. Moreover, cities have begun to initiate their own policy relaxation – for example, Zhengzhou became the first city to relax curbs on second homes and have cut the down-payment ratio for buyers that already own one home and have no outstanding mortgage to 30% from 60%. Moreover, policymakers are now drafting nationwide rules to make it easier for developers to access funds from sales still held in escrow accounts to help further alleviate the liquidity crunch. For now, RockCreek remains on the sidelines.

Despite some of these positive developments on easing on liquidity, GPs have been cautious about entering the sector more aggressively as they believe credit conditions continue to remain tight as easing measures from policymakers have, so far, been piecemeal and haven't had a significant impact on the physical market, as well as the delay in the release of financial statements. At this point, GPs are nibbling only at very specific opportunities that have limited further downside as pricing reflects worst case recovery value and there is significant positive convexity in the event of a recovery. The distressed opportunity is attractive, but timing remains uncertain.

Investors need to stay vigilant and both capital deployment and GP-selection will be critical to future outperformance. Avoiding commitments to the large mega size funds, focusing on sourcing and partnering with GPs that are raising smaller funds, and looking for alignment of interest through strong

GP commitments is necessary. Nimble funds that can take advantage of less competitive transactions should generate outsized returns. The graph below shows that the smaller sized funds have consistently outperformed their large sized peers since 2008.

Performance by Vintage and Fund Size



Source: 2022 Preqin Global Private Debt Report