Private Credit

With market optimism fading in response to continued macroeconomic and geopolitical uncertainty, certain private credit sub-strategies were validated this quarter (as they have been throughout the calendar year), as a truly reliable and uncorrelated source of cash flows.

Specifically, those strategies that are geared towards delivering downside-protected, contractual sources of income have remained steadfast, providing valuable capital to investors whose liability payments, strategic asset allocations, and opportunistic endeavors have been frustrated by mark-to-market pressures. Floating rate, senior secured risk – when underwritten properly – has provided minimal exposure to either credit risk or interest rate duration. It also comes in many different forms from corporate loans to asset-based loans to bank risk sharing transactions, providing additional diversification benefits though diversification of underlying income source and collateral type.

In the context of already diversified portfolios, we've been focused on understanding how illiquidity premium – the spread over what can be achieved in the public markets – has repriced across different income-oriented sub-strategies. Pre-quantitative tightening, with a risk-free rate of zero, most income-oriented strategies were delivering gross unlevered yields in the high single digit, low double-digit range. Now that the rates have moved 300-400 basis points higher, one would expect gross unlevered yields to increase by at least this much.

However, we have found that private corporate lending has actually seen spread compression and a degradation of illiquidity premium. Even more interesting, the exact opposite is true with asset-based loans. Despite the asset-based (often inflation resilient) collateral, the misperception of risks has caused certain asset-based strategies in the consumer and real estate sectors to experience spread widening and a build of illiquidity premium. Not all income-oriented strategies are created equal, and we are remaining vigilant in our pursuit of superior risk-adjusted returns.

Optimizing income and building durable, all-weather portfolios does not preclude us from looking to opportunistically purchase mispriced risk. While we believe there are opportunities to be found in the United States, we also recognize that recent currency movements and the ever-strengthening US dollar has kept many investors tethered domestically, missing a potential opportunity set abroad. Europe is a less competitive, heterogeneous market that is facing the ubiquitous and interrelated developed market problems of rising rates, inflation, and supply chain constraints, but also dealing with a systemic energy crisis and a financial system still plagued with several trillion euros of unresolved loans stemming from the Global Financial Crisis.

Increased credit defaults and the disposition of non-performing and challenged assets at a steepening discount appears inevitable. Separately, the further conservatism and bank retrenchment that results from the implementation of the Basil IV regulations should increase opportunities to buy performing assets from distressed sellers in regions like Australia and New Zealand, which have already seen a mass exodus of foreign alternative capital providers.