PRIVATE CREDIT

With the US high yield and leveraged loan markets yielding 8.5% and 9.3%, respectively, it is not surprising that investors continue to view credit as attractive, relative to other asset classes. Private corporate direct lenders also continue to deliver a healthy illiquid premium (i.e., excess return over their public market equivalent), achieving spreads over SOFR of 600 bps to 800 bps for sponsored transactions and 750 bps to 1,000 bps or more for non-sponsored transactions. Considering the added return that can be achieved through upfront fees, call protection, and other structural features, private lenders may need to retire the adage, "generating equity-like returns" for the foreseeable future.

However, corporate credit yields and spreads – while attractive on an absolute basis – reflect the risk premium investors must receive for bearing elevated credit risk. This is particularly relevant for companies exposed to rising interest rates (and other inflationary pressures) through their debt structures or inability to pass high debt expenses on to consumers or customers. At RockCreek, we think we are still far from a true distressed cycle in the United States; however, the public markets have begun to show signs of stress. According to JP Morgan market research, year-to-date defaults and distressed exchanges in the US are currently on track to be the market's third largest annual total on record by year end. Although par-weighted high yield bond and leveraged loan default rates remain near their 30-year monthly averages, there has been a clear upward trend that will likely only accelerate into 2024 and 2025 at or ahead of upcoming maturity walls.

Corporate credit risk is heightened, and investors should not be complacent or blinded by the promise of attractive total returns. RockCreek has continued to recognize opportunity in the breadth of the private credit markets and ability to generate superior risk-adjusted returns outside of the corporate sector, whether it be through taking asset-based risk or identifying less-discovered, more esoteric market opportunities.

One such opportunity is the $14 trillion mortgage servicing rights (MSR) market. MSRs are a contractual agreement governing the right to service a residential mortgage, thereby generating a stable source of revenue through a monthly servicing fee that is based on the borrower's mortgage balance. MSR payments are senior to the mortgage and bear similar risk characteristics to a mortgage IO derivative. Every agency mortgage originated must have an MSR. Despite its size, general complexity and significant barriers to entry have discouraged new alternative entrants into the market, while existing participants – primarily the large money center banks – are decreasing their footprint due to burdensome regulation. Despite bearing no credit risk through an implicit or explicit guarantee from the GSEs, agency backed MSRs pay a 9% to 10% unlevered yield in the current market environment. This return can be enhanced through simple interest rates hedges and modest leverage. While prepayment risk on current vintage MSRs is a consideration, the retrenchment by banks is creating an interesting market dynamic to buy 2020/2021 vintage MSRs, whereby the underlying mortgages are 300 bps to 400 bps below the prevailing mortgage rates – the risk of refinance is low. Although this opportunity may be more complex than private corporate lending, it would appear to present a superior risk-adjusted return.

Another theoretical question is around the value of non-US exposure, particularly when it comes to assessing income-oriented strategies. While most investors recognize the value of geographic diversification, they also highlight the lack of risk premium that can be achieved for taking jurisdictional risk. Generally, we would agree and have concentrated much of our focus on opportunities located within the US. However, certain markets may offer outsized risk-adjusted returns relative to the US, where prevailing regulations and barriers to entry have created a unique market environment to exploit. One such area is asset-based lending in Australia and New Zealand – two smaller markets that have been predominantly served by a small number of local banks. The combination of market size, Basel IV implementation, demographic trends and net migration, and undersupply has created a unique opportunity to provide debt financing for residential development. These asset-backed loans can achieve high teen returns in a region that arguably has better creditor rights than the United States and developed capital markets to facilitate inexpensive currency hedging.

Although corporate lending in the United States can generate attractive total returns for investors, there are notable risks, and the opportunity set today is broad for investors willing to source through a wide aperture. And while corporate direct lending will likely remain a core component of most institutional private credit allocations, we believe the inclusion of other risk factors can significantly enhance the risk-adjusted return profile of a portfolio.