CVC Credit Perspectives

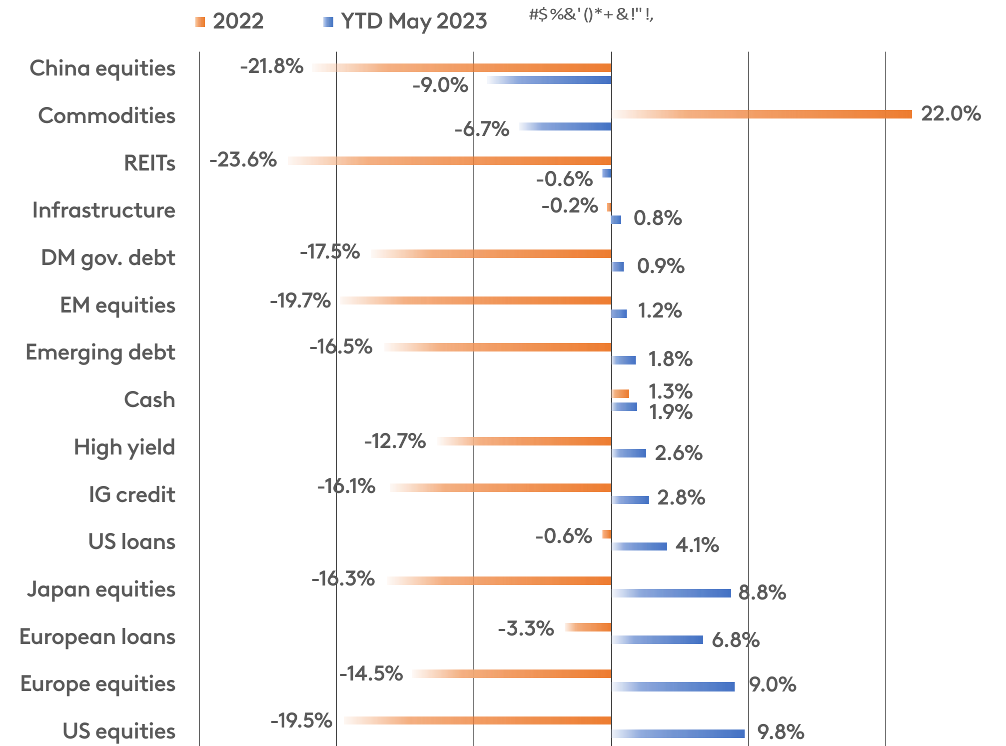
Attractive opportunities across global credit

June 2023

Market update

After a tumultuous 2022 for markets, 2023 has seen its fair share of volatility and unexpected stresses. Trouble in the banking sector, starting with the failure of Silicon Valley Bank which resulted in the shutdown of Signature Bank by the federal regulators, and subsequently Credit Suisse's catastrophic liquidity crisis in Europe, sent shockwaves through equity and credit markets. While these banks' situations were unique, their problems were the result of broader fragilities in the sector stemming from tight monetary policy. With inflation persisting, investors continue to be focused on earnings compression and global central bank policies.

Exhibit 1
Performance Across Asset Classes



YTD shows year to 31 May 2023. Indexes or prices used are: U.S. equities - MSCI USA Index, EM equities - MSCI Emerging Markets Index, Europe equities - MSCI Europe Index, Japan equities - MSCI Japan Index, China equities - MSCI China Index, DM gov. debt - Bloomberg Global Treasury Index, Emerging debt - JPMorgan Emerging Market Bond Index (EMBI) Global Composite, High yield - Bloomberg Global High Yield Index, IG credit - Bloomberg Global Credit - Corporate Index, US loans – Morningstar LSTA US Leveraged Loan Index, European Loans – Morningstar European Leveraged Loan Index, Commodities - Commodity Research Bureau (CRB) Index, Cash - Bloomberg U.S. Treasury Bellwethers: 3 Month Index, REITs - S&P Global Real Estate Investment Trust (REIT) Index, Infrastructure - S&P Global Infrastructure Index.

The outlook for Europe has improved, but risks to the downside remain. Gas prices dropped below €30 in May, for the first time since H1'21 and consumer confidence is picking up. Further, corporate earnings – though down 6% year over year – are holding up better than initially expected. Notably, this is the first negative year on year growth in earnings since Q4 2020. Geopolitical tensions continue to be a key risk and if they intensify, could lead to more energy and food price spikes, thereby pushing inflation up. Potential harsh weather conditions could exacerbate imbalances in energy markets, particularly ahead of the next winter.

Although eurozone inflation rose slightly in April, a sharp retreat in bank lending and slowdown in core inflation led the European Central Bank (ECB) to raise its key rate by a quarter percentage point at their May meeting, the smallest move since the bank started tightening last summer. The ECB has increased its deposit rate from -0.5% last July to 3.25% with its latest move. President Christine Lagarde warned the Bank had "more ground to cover."

Across the pond, the US Federal Reserve (Fed) also raised its benchmark interest rate by a quarter percentage point in its May meeting,

its tenth consecutive increase in just over a year. This move brings the federal funds rate to a new target range of 5-5.25%. The meeting occurred just two days after First Republic became the third bank to be seized by US regulators in the past few months. With the combination of failing banks and marginal declines in inflation, the Fed signaled a potential pause in their hiking campaign. Post meeting, the yield on the 2-year Treasury note fell to its lowest level in a month on expectations that this may be the Fed's last increase of the current cycle. At the time of this writing, there is a growing camp that believes the Fed will begin cutting rates later this year, however, as inflation remains sticky, it is unlikely that the Fed will be as accommodative as the market believes. Furthermore, with the passing of the debt ceiling deal, the market can now focus on other macro data.

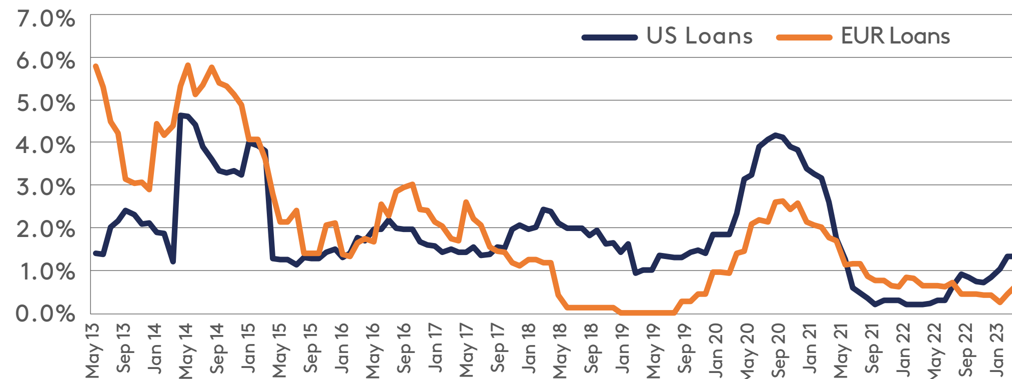
Performing Credit Markets

Leveraged credit started 2023 strong, with the ICE BofA US High Yield Constrained Index posting a 3.7% return and the Morningstar LSTA US Leveraged Loan Index up 4.1% through May. The positive performance was led by lower quality tiers (B-rated and CCC-rated paper), as investors dipped down in credit quality to pick up extra yield. Although fundamentals are still healthy, they have deteriorated as earnings growth has slowed. With tighter financial conditions and still elevated inflation, we continue to monitor the impact on company liquidity, interest coverage, and leverage ratios. Specifically, we continue to run several stress tests on our portfolio holdings, assuming base rates remain higher for longer (assume terminal rate of 6.0% in the US and 4.5% in Europe) and stressing earnings, to see the impact on interest coverage ratios. Downgrades and defaults have picked up in the market, as we had expected and referenced in our January Credit Perspectives. Coming into 2023, our Performing Credit business was defensively positioned, with a bias towards larger and highly rated issuers that we believe should be more insulated from these downgrades and defaults.

The 12-month trailing, par-weighted US high yield default rate increased to 2.18% in April, while the European high yield default rate came in at 1.2% (source: J.P. Morgan). Leveraged loans also saw an uptick in defaults – 12-month trailing default rates of 1.31% and 0.60% for the US and Europe, respectively (source: Pitchbook Data). As US issuers had to cope with ~550bps of rate hikes while European issuers only had to deal with 350bps of rate hikes, interest coverage metrics for EUR only issuers are in better shape. Further, there has been more interest rate hedging in Europe relative to the US, which again has translated to relatively better interest coverage amongst European companies. Our expectation is that downgrades and defaults will continue to rise, particularly for highly levered borrowers and/or those in cyclical industries. Furthermore, we expect heightened macro uncertainty to drive higher market volatility for the balance of the year. As such, credit selectivity remains paramount given the dispersion we are likely to see across geographies, industries, and issuers.

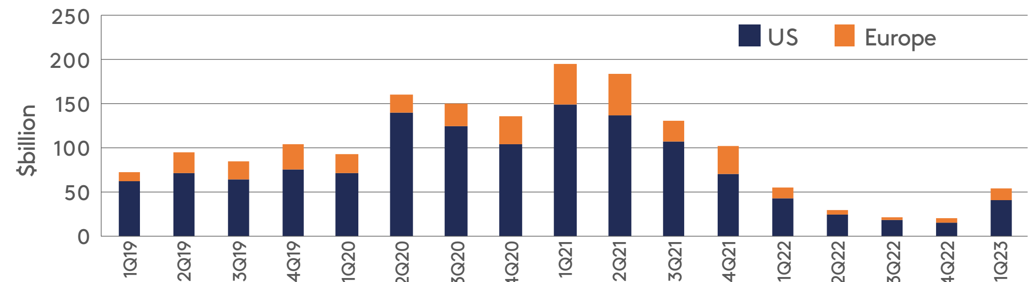
The technical backdrop so far this year has been positive, leading to the solid returns through May. Activity in the primary market has been limited thus far in 2023. Through the end of Q1, high yield issuance totaled $54 billion across US and Europe (2% lower than same period in 2022), while loan issuance totaled $74 billion (down 61% compared with the same period in 2022). Mergers and acquisitions (M&A) and Leveraged buyout (LBO) transactions remained scarce, as refinancings continued to dominate supply. When you exclude refinancings, the volumes are markedly lower for both asset classes. On the demand side, loan retail outflows were offset by Collateralized Loan Obligation (CLO) formation. Globally, we have seen close to $55 billion in CLO issuance YTD through May 15. This compares with $66 billion at this point last year. We anticipate that a continued lack of primary issuance should provide a technical tailwind for both high yield and bank loans that should create an artificial floor on price levels.

Exhibit 2
Lagging 12-Month Loan Default Rate: Principal Amount



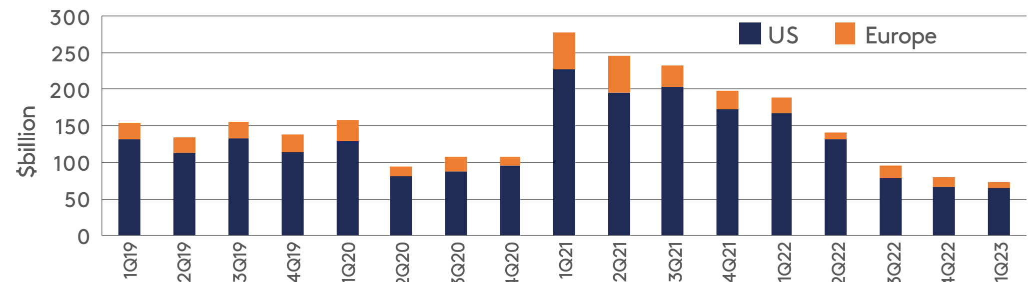
Data through April 30, 2023. Source: Pitchbook|LCD; Morningstar LSTA US Leveraged Loan Index; Morningstar European Leveraged Loan Index

Exhibit 3
High Yield Issuance: Quarterly



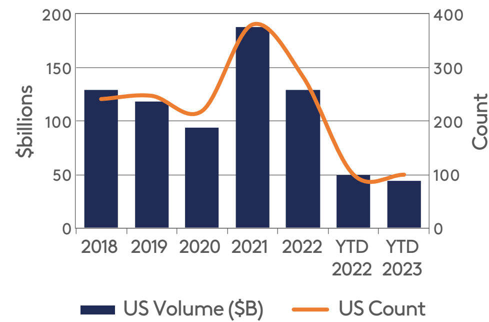
Data through March 31, 2023. Source: Pitchbook|LCD

Leveraged Loan Issuance: Quarterly

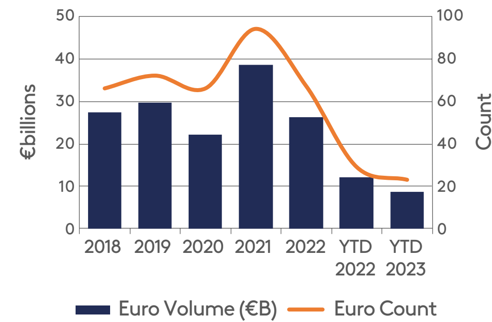


Data through March 31, 2023. Source: Pitchbook|LCD

Exhibit 4
CLO Issuance



Data through May 15, 2023. Source: Pitchbook|LCD

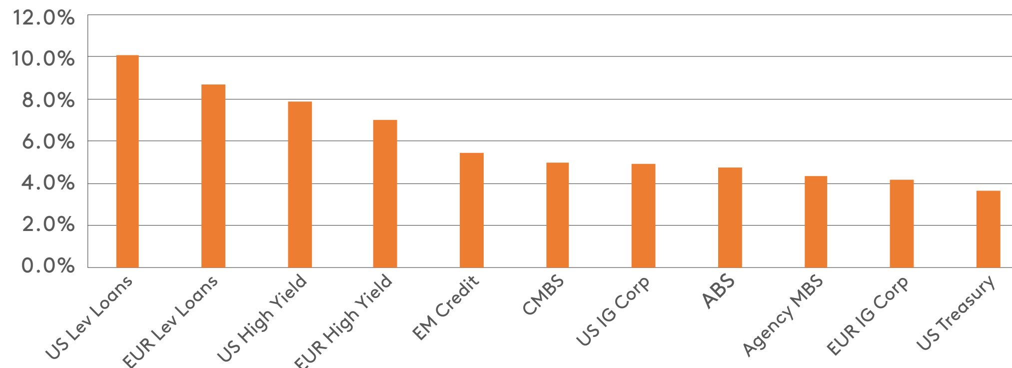


Data through May 15, 2023. Source: Pitchbook|LCD

Despite the uncertainties markets continue to face – the impact of central bank policy, stubborn inflation, a potential economic slowdown, rising downgrade and default risk – we believe pockets within fixed income remain quite attractive. We expect this elevated volatility and the shifting focus from monetary policy to underlying credit fundamentals, to create risks and opportunities for active credit managers. We continue to be constructive on loans and high yield given their yield profiles.

Today, we continue to have a slight preference for 1st lien loans over high yield. That said, we are evaluating the appropriate time to add more fixed rate exposure via high yield, as we anticipate the Fed is likely close to the end of its hiking cycle, which will keep interest rates high for the time being while the U.S. economy potentially slips into recession. We continue to evaluate macro conditions between the U.S. and Europe and the relative value between loans and bonds and will look to position our portfolios accordingly.

Exhibit 5
Yields across fixed income



Note: We use the Bloomberg-Barclays indices for the US Treasury, IG Corp, MBS, CMBS and ABS markets, the CEMBI Broad Diversified IG index for the EM credit market, the ICE BofA indices for the high yield markets, and the Morningstar LSTA indices for the leveraged loan markets. Yields as of April 28, 2023.

Source: Bloomberg-Barclays, PitchBook|LCD, ICE Data Indices, J.P. Morgan Markets

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