BENEFIT STREET PARTNERS

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SPECIAL SITUATIONS MARKET OUTLOOK: FASTEN YOUR SEATBELTS

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Fasten your seatbelts…. credit markets are going to be bumpy. Events that once seemed unlikely (high inflation, limited central bank tools, rising rates, unexpected war, slowing global growth, margin compression) are all transpiring. Economic and market outlooks are uncertain. An anomaly? For the most part, no. While war and sky-high inflation are certainly not the norm, many dynamics are consistent with conditions that existed for decades pre-GFC, an era characterized by a persistent special situations opportunity set. However, there is one critical difference between the two eras: a massive debt market, fueled by the explosion of the leveraged finance market. In this piece, we summarize key dynamics at play in credit markets and explore how best to capitalize on the bumps that are creating the beginnings of a fertile special situations investment environment.

Key Takeaways

- An end to the highly anomalous post-GFC era is near, with a return of traditional economic cycles and operating environments underscored by higher cost of capital, sustained dislocations, and a rolling opportunity set
- Leveraged credit markets have more than doubled ($4.2 trillion today versus just $1.7 trillion in 2010), creating an unprecedented amount of leverage in the financial ecosystem[1]
- Macroeconomic headwinds and uncertain topline performance without the buffers of zero interest rates and central bank liquidity injections are creating volatility and dispersion in the market. The stressed/distressed opportunity set has increased ~400% YTD from $75 billion to nearly $300 billion[2]
- Numerous opportunities for equity-like returns in credit both in primary and secondary markets; opportunity set and return potential can expand significantly in the event of a prolonged global recession
- In an uncertain environment, we believe it is prudent to be positioned in a portfolio focused on asset coverage in industries that are historically recession resilient

[1] Leveraged credit market sizing includes dollar value of outstanding high yield corporate bonds and broadly syndicated leveraged loans, in addition to private credit dry powder. Source: Goldman Sachs Global Investment Research and Preqin.
[2] Defined as loans wider than 1000bps and bonds trading below 80. Source: Bloomberg, as of December 30, 2022.

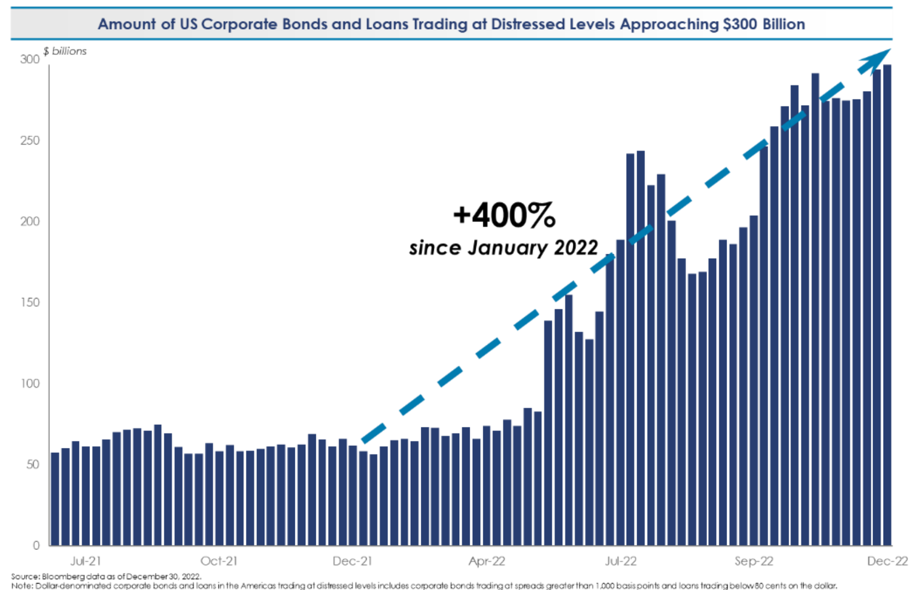
Post-GFC to a Reversion to the Mean

It seemed as though low rates, a dovish Fed, and easy liquidity would persist forever post-GFC. Low cost of capital, borrower friendly documents, and central banks willing to quell any hiccup in financial conditions with sizable liquidity injections paved the way for massive debt issuance. Leveraged credit markets grew ~150% from \$1.7 trillion in 2010 to over \$4.2 trillion in 2022.[3] Then, the unexpected. A pandemic, supply chain issues, and labor shortages, combined with a massive growth in money supply, have led to inflation levels not contemplated in decades. Seemingly behind the inflation curve, central banks have been forced to dramatically raise interest rates, leading inevitably to slowing global growth. These higher levels of inflation, and the impact on interest rates and central bank activity, lead us to believe credit markets will have to contend with a far less forgiving borrower environment, one more akin to the late 1990s and early 2000s. Cost of capital for U.S. companies rose dramatically in 2022, driven by an increase in both base rates and spreads. Throughout the post-GFC period, the yield-to-worst on US high yield bonds averaged 6.6%; in late 2022, it has reached as high as 9.6%.[4] The market has changed behaviorally as well. Financial missteps are no longer forgivable. Missed earnings, increased leverage, and messaging on anemic guidance are now punishable offenses. Cycles and leverage could become significantly more challenging for companies, creating regular pockets of opportunity as opposed to the episodic boom/bust cycle that had become the hallmark of the post-GFC world.

	Late 90s to GFC:	Post-GFC:	2022 Onward:
Inflation	2.5% *Average CPI*	1.9% *Average CPI*	**7.1%** ***Current CPI***
Fed	\$814 billion *Average Size of Fed Balance Sheet*	\$2.1 trillion to \$8.8 trillion *Growth of Fed Balance Sheet*	**Fed Intervention?**
Cost of Capital	10.6% *Average High Yield YTW*	6.6% *Average High Yield YTW*	**9.0%** ***Current High Yield YTW***
Globalization	Rising	Peak	**Falling**
Financial Markets	Punish Missteps	Forgiving	**Punish Missteps**
Distressed Opportunity	↑	↓	↑

The Beginnings of an Opportunity Set Explosion

In less than two quarters, the stressed/distressed opportunity set increased almost 400% from \$75 billion to nearly \$300 billion[5], all without a defined "shock" to the financial system. A recession, seemingly likely in the next six to twelve months, would push this opportunity set to an even larger quantum. A phrase that many had forgotten (or had never heard of) is beginning to resurface: "good company, bad balance sheet". Prior to 2022, to meet typical special situations return targets, investors were forced to target more challenged businesses through highly labor intensive and episodic opportunities, oftentimes at higher attachment points. Today, higher costs of capital and tighter financial conditions have limited corporate flexibility. As a result, good businesses that have made mistakes can become stressed, providing very attractive opportunities for special situations investors. An expanded opportunity set, and the ability to buy good businesses at a discount with process-oriented catalysts to help close the gap, should generate very attractive returns while limiting downside.



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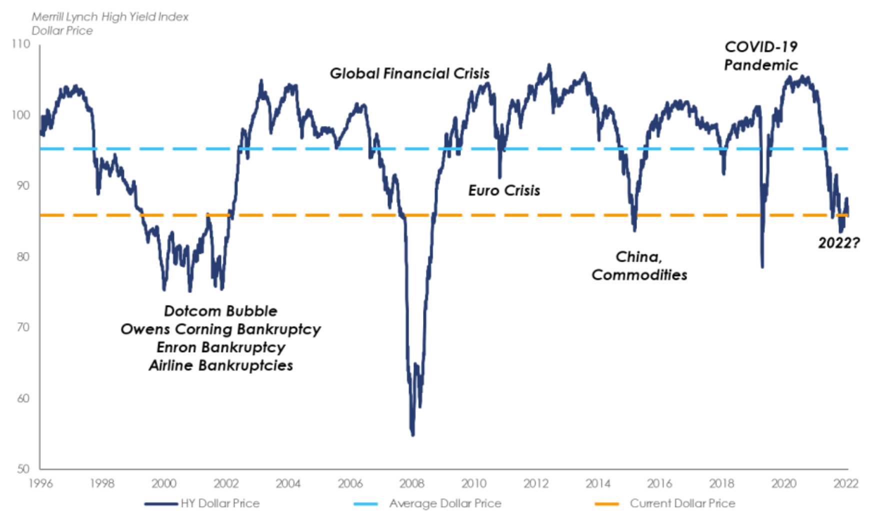
[3] Leveraged credit market sizing includes dollar value of outstanding high yield corporate bonds and broadly syndicated leveraged loans, in addition to private credit dry powder. Source: Goldman Sachs Global Investment Research and Preqin.

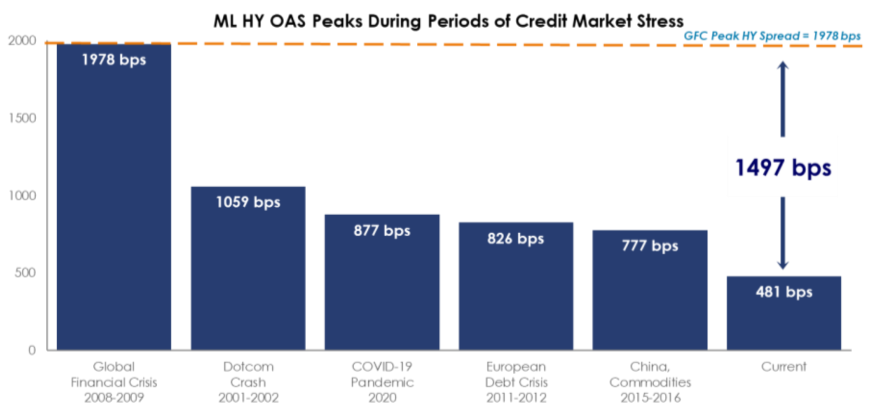
[4] Data for the ICE BofA US High Yield Index sourced via Bloomberg as of December 31, 2022.

[5] Defined as loans wider than 1000bps and bonds trading below 80. Source: Bloomberg, as of December 30, 2022.

Why Wait for Spreads? Or a Recession?

A propensity to focus on spreads (which do have ample room to widen when compared to past dislocations) has obscured the fact that absolute yields in credit are attractive. U.S. 5-year government bond rates have widened from ~1% at the end of 2021 to 4% at the end of December 2022. Dollar prices in the U.S. high yield market are the lowest they have been since the GFC, excluding the very brief China/commodities crisis and COVID-19 pandemic. Primary markets have slowed, limiting borrower access to the easy capital to which they have become accustomed, leading to both increased borrowing costs and an increased interest in creative capital solutions. At the same time, inflationary pressures are materially impacting corporate margins and profitability, leaving more and more companies in need of near-term capital. These are the two critical dynamics today that are leading to primary and secondary opportunities. A recession would expand an already attractive investment landscape, creating a massive opportunity to identify even higher returning investments in both the primary and secondary markets. However, an attempt to time the bottom is never advisable, or one may miss the boat entirely. The time is now. Historic moves in prices and yields have already started, generating investments with uncorrelated, event driven catalysts, better attachment points, compensation for process, convexity to rates, and downside cushion via lower prices.





Conclusion

Today's markets offer attractive opportunities in credit that cannot be ignored even when adjusted for highly uncertain headwinds and a glut of leverage. We believe the best risk/reward today lies within a portfolio of uncorrelated and bespoke process-oriented investments, event driven themes, and names that stand to perform during a recessionary and inflationary environment. Current dynamics are creating these investments with greater convexity, at lower prices and lower attachment points. It is prudent to allocate capacity today to be able to deploy dollars now and into an accelerating opportunity set.

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