

INSIGHTS FROM CFA SOCIETY SINGAPORE

# Risk and reward in stressed and distressed debt

Nominal interest rates now outpace the rate of economic growth. This has significant implications for debtors whose earnings grow slower than the interest on debt



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WHAT is the current outlook for credit markets? Interest rates had been in secular decline since the 1980s. In the aftermath of the global financial crisis, rates hovered near zero as central banks embraced quantitative easing and flooded markets with liquidity. Among other effects, these monetary policies elevated the valuations of most assets, including private and public debt.

This trend came to an end in 2022 when central banks began to raise rates and tighten credit conditions to tame inflation. Today, investors must navigate this transition. In terms of economic expression – and to take a page from Thomas Piketty – we have shifted from an  $r > g$  to an  $i > g$  world. That is, from one where the real rate of return ( $r$ ) exceeds the rate of economic growth ( $g$ ) to one where nominal interest rates ( $i$ ) outpace the rate of economic growth.

This has significant implications for debtors whose earnings are likely to grow slower than the interest accumulated on borrowed funds. As our parents might say, this is likely to “end in tears”.



For investors, the risk focus has shifted from the rising cost of capital to refinancing. PHOTO: PIXABAY

Simply put, many businesses and investments have not been tested. Since 2009, save for a brief period in early 2020, nominal growth has outpaced nominal rates. Warren Buffett famously said: “You only find out who is swimming naked when the tide goes out.”

Well, the tide is going out and as businesses refinance at higher rates, default rates and distressed exchanges are likely to increase at the same time.

When revenue grows more slowly than the cost of financing, especially over an extended period, businesses feel the pinch. Add to this the large amount of US corporate fixed-rate debt due in the next couple years and banks and other traditional lenders getting

cold feet, among other factors, and many businesses will be left vulnerable. Some are rolling over debt early, even at higher rates, to avoid potentially not being able to do so at all later on.

Costs for high-yield borrowers are hovering near 9 per cent. For investors, the risk focus has shifted from the rising cost of capital to refinancing, period.

Year to date, total US corporate bankruptcies have been at their highest level since 2010.

The pace of defaults is expected to continue if not increase in 2023 and 2024, due to the lagged impacts of higher rates, slower economic growth, and inflation. This is not business as usual.

Investors’ risk appetite has also changed. They may have felt com-

pelled in the past to venture further out on the risk continuum to capture yield.

But now that the risk-free rate has increased, they have less need to do so. The tumult in the US regional banking sector, with the March collapse of Silicon Valley Bank and Signature Bank and the failure of First Republic in May, has cast a pall over lending. A recent report on US economic activity showed a slowdown in job growth and a near-term deterioration of business prospects.

Where does that leave asset allocation in public and private credit? Rising rates have pushed bond prices down. Notwithstanding the ongoing love affair with private debt, there is an overlooked and growing opportunity set in the

public debt markets that appears mispriced relative to risk and return.

In 2020 and 2021, public and private debt was priced at par (or above), with private debt offering a liquidity premium in the form of a fat coupon. Today, the situation is different, with the edge going to the public markets. There are several reasons for this.

In the public debt market:

- Pricing is determined in the open market and adjusts to changing market conditions.
- There is greater price transparency. This brings more price volatility and more opportunities to acquire assets below par to increase the margin of safety.
- Greater liquidity makes exiting a position easier should the risk/reward balance change or a better prospect for deploying capital develop.
- Companies that issue public bonds have proven their business models in the market.
- There is greater diversification of bonds in the public markets.
- Public debt has corrected more than private debt in the rising interest rate environment.

In every economic cycle, some businesses with solid growth profiles will nevertheless carry some debt. For example, starting in 2015, the energy sector was severely stressed while other areas – hospitality, for example – were not.

In 2020, amid the peak of Covid wave, hotels, movie theatres, and automobile rental services were

struggling, but bakeries were doing fine.

At some point, the prices in stressed sectors fell far enough that investors were compensated for the risk. Selective investors could find companies with high-quality assets and strong competitive advantages. The occasional price volatility in publicly traded bonds offers the potential to exploit mispricing.

In the four previous default cycles, the average drawdown of lower-rated high yield was about 30 per cent and the average recovery approximately 80 per cent over the ensuing two years. With the high-yield bond market down roughly 18 per cent in 2022, investors are beginning to see good opportunities develop in the eventual recovery in lower quality credits.

Investors looking to diversify their portfolios and take advantage of the valuation gap between public and private bonds should consider an allocation to public credits. Among the assortment of small to mid-sized companies lies an attractive risk-reward proposition.

Due to their size, these companies experience greater capital scarcity and investors face lower competition from other capital providers. Further, as credit conditions remain tight and refinancing costs increase, more quality businesses will need to raise capital.

The writer is a stressed and distressed credit investing specialist