BARINGS

— 2022 OUTLOOK —

THE NEW NORMAL COMES INTO VIEW

Public & Private Credit Market Roundtable

In this roundtable discussion, our credit market experts across public and private markets offer their views on everything from inflation and the direction of interest rates, to where they're seeing pockets of value.

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Greg: 2021 was a year of strong recovery, though not without its ups and downs. Martin, can you start by discussing the fundamental backdrop for developed market fixed income issuers today?

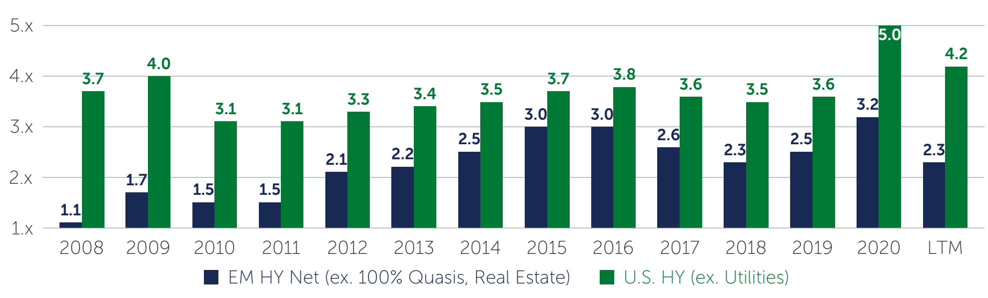
Martin: It was certainly a year of recovery. Many companies now look fairly well-positioned heading into 2022, supported by the continued re-opening of economies and largely successful vaccine rollouts around the world. Earnings have been improving across the board, and defaults are expected to remain low for the foreseeable future. At the same time, employment levels continue to improve, and the consumer looks relatively healthy. While there are concerns around inflation amid rising raw material costs and supply side disruptions, many companies have been able to pass those costs through to the consumer. That said, the casualties from the tangled supply chain will have repercussions for some time to come, and we have likely not yet seen the full effects of wage inflation—both of which could lead to some erosion of companies' margin levels.

Greg: Tunde, how does Martin's assessment stack up with what you're seeing as you look across the EM corporate debt landscape?

Omotunde: Similar to developed markets, corporate fundamentals across EM have improved dramatically amid the vaccine rollout and persistent demand for commodities. Revenues and EBITDAs have largely recovered from the double-digit declines of last year, and net leverage is now below 2019 levels for many corporates. EM corporate default rates have also remained low relative to historical standards.

As we think about the year ahead, the potential headwinds that come to mind are similar to what Martin mentioned—namely that factors like supply chain bottlenecks and chip shortages introduce more inflationary pressure for EM corporates. While most companies have been able to pass higher costs to the consumer, there are questions around how much margin compression may result from continued inflationary pressures going forward. On the positive side, we've seen a significant amount of refinancing in 2020 and 2021, meaning many companies have locked in lower funding costs and now have a stronger buffer against these pressures, which should help keep corporate fundamentals relatively stable.

Figure 1: EM Corporate Fundamentals Look Relatively Healthy

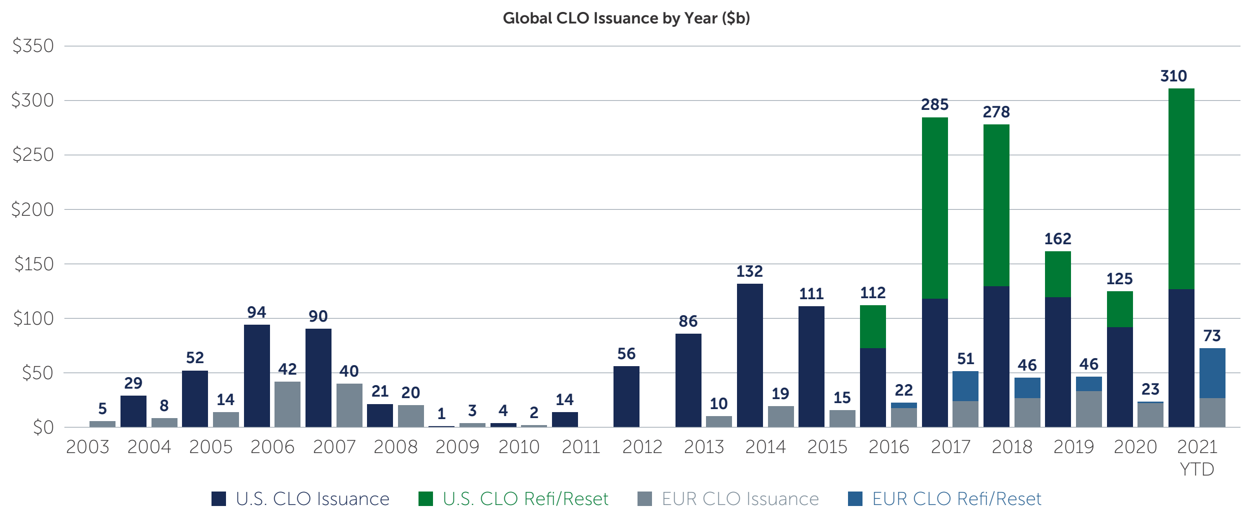


Source: J.P. Morgan. As of September 30, 2021.

Greg: Like many risk assets, the CLO market has been on a bit of a rollercoaster ride since the onset of pandemic. Taryn, how would you assess the overall health of the market at this point?

Taryn: The CLO market looks healthy overall, with credit metrics and default expectations continuing to improve. From a liquidity perspective, all term structures appear to be well supported. While there has been heavy supply in the new issuance calendar, it's been met with strong demand—notably, from a more diverse investor base. Early in the pandemic, when CLO assets were trading at depressed prices, we saw an influx of opportunistic buyers. That's not the case anymore, with banks and other institutional buyers having largely returned to the asset class over the last year and contributing to its improved liquidity.

Figure 2: Heavy CLO Supply



Source: J.P. Morgan. As of September 30, 2021.

Greg: Turning to the private markets—Mark, are you seeing similar or different dynamics?

Mark: The dynamics are a little different given the illiquidity of the private credit market, which means there is limited to no ability to trade out of assets. For this reason, we tend to favor defensive sectors and issuers over those that are more cyclical in nature, which means our portfolios are somewhat insulated from macro trends and volatility. Of course, our asset class is clearly not immune to macro events, and we continue to keep an eye on factors like inflation, supply chain disruptions, labor shortages and energy prices.

In terms of the health of the market, private credit has clearly demonstrated its resilience coming out of the pandemic. I would note, however, that the dynamics shaping European private credit today look a bit different than they did pre-pandemic. In particular, we have seen the consolidation of lenders over the last year—whereas 10 lenders may have seen a deal prior to the pandemic, today that number is often more like two or three. This can materially impact the types of transactions a manager is able to invest in, which makes access to deal flow, and avoiding adverse selection, as important as ever.

Greg: John, your role is unique in that you're looking across private assets more broadly. Are there any broader underlying trends you're watching in terms of the development of the private markets themselves that may impact the investment landscape?

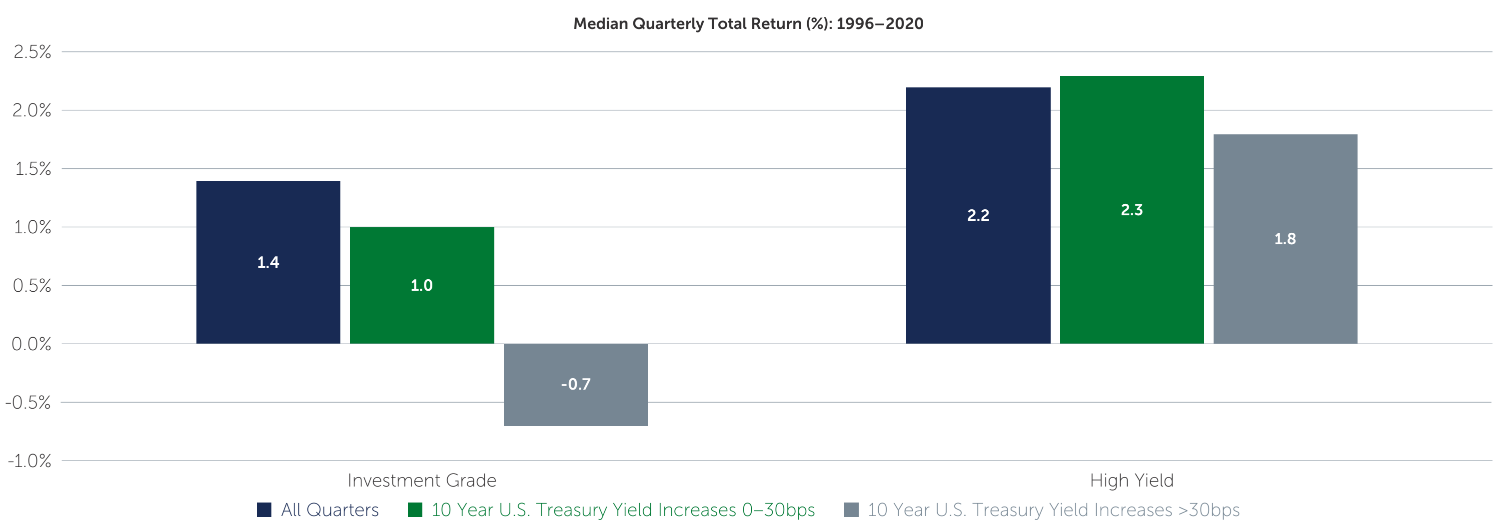
John: Thinking about the evolution of private assets, a few trends come to mind. The first is that there is a lot more capital flowing into private markets. That said, strong demand continues to be met with healthy supply, which has kept spreads at attractive levels. Given that certain public market spreads have been very tight, the private market—from direct lending, to infrastructure debt, to private asset-backed securities—continues to offer a significant potential illiquidity premium. Another key trend we're seeing is growing interest in multi-strategy mandates, which is partly the result of there being more asset classes to invest in. Whereas investors may have historically looked at private placements, infrastructure debt, and real estate, that opportunity set has expanded to include areas like private asset-backed securities and private residential mortgage loans. Of note, as investors are increasing their private asset allocations, they're increasingly gravitating toward managers who can provide streamlined access to more than one of these markets.

Greg: Speaking of looking across a wide range of asset classes—Martin, as you look across markets ranging from high yield, to public asset-backed securities, to EM debt, how worried are you about higher rates?

Martin: Ever since the Lehman's crisis over a decade ago, central bankers have made it their priority to calm the markets, and to over-communicate with markets—and that's exactly what we're seeing across the board today. This suggests that any forthcoming rate increases will be widely telegraphed, and less likely to surprise the markets.

That said, rates will eventually rise. And when they do, some fixed income asset classes will inevitably face greater challenges than others. But it is worth noting that there are many options across the broader fixed income landscape, including certain asset classes that can provide protection against interest rate moves when they do occur. Shorter-duration investment grade strategies come to mind, as do high yield bonds, which are shorter in duration relative to some traditional fixed income products. There are also benefits to considering variable or floating rate asset classes such as CLOs, public and private loans, as well as certain securitized instruments.

Figure 3: The Impact of Rising Rates



Source: Bloomberg Barclays Research. As of February 28, 2021.

Greg: Turning to emerging markets, China has dominated headlines lately. Tunde, how are you thinking about this from an EM debt perspective? Do you see the potential for contagion into developed markets?

Omotunde: China has definitely been one of the most topical markets for us in 2021, with the Chinese government implementing sweeping regulatory changes across sectors like real estate, tech and education. While these measures have created significant volatility and spread widening, we think the likelihood of contagion outside of China is very low. For one, in order for contagion to occur, there needs to be a cross-border mechanism. Looking at the real estate sector as an example, most of the lending comes from Chinese banks—international banks have very little exposure to the sector. There are also very few international investors with exposure to Chinese real estate sector bonds, suggesting the volatility and losses within the sector will not necessarily translate into outflows or contagion outside of the region.

Greg: To finish up, I'd like to get views from this group on both opportunities and risks. Specifically, what is the top risk you see heading into 2022, and where do see the most compelling opportunities?

Martin: With asset prices where they are today, there are a number of risks that could have a fairly disruptive effect on markets going forward—from inflation and central bank activity, to geopolitical events and ongoing disruption from COVID. However, if I had to name one risk, it would probably be the amount of cash that's sitting in these markets right now. As I sit here today, the equity markets don't feel overly bullish about the outlook; they're still near record highs, despite concerns around inflation. That is to say, any number of these risks could cause a decent price movement on the liquid side, which would be in keeping with what we've seen over the last 15 years. From Lehman's, to the sovereign debt crisis, to the 2016 commodity weakness, to the volatility in the fourth quarter of 2018, to COVID—we've seen big market movements or corrections every couple of years.

If you expect a disruption is likely, there is a range of opportunities to choose from. If you're more bearish, for instance, asset classes like liquid loans may look attractive, as they tend to be relatively stable and typically return to par pretty quickly after big market events. That said, there is also value in having a flexible mandate. The world has shown us that opportunity sets between credit asset classes can change very quickly, underscoring the importance of investing with a manager that can monitor events in real time and dynamically allocate into opportunities as they present themselves in the market.

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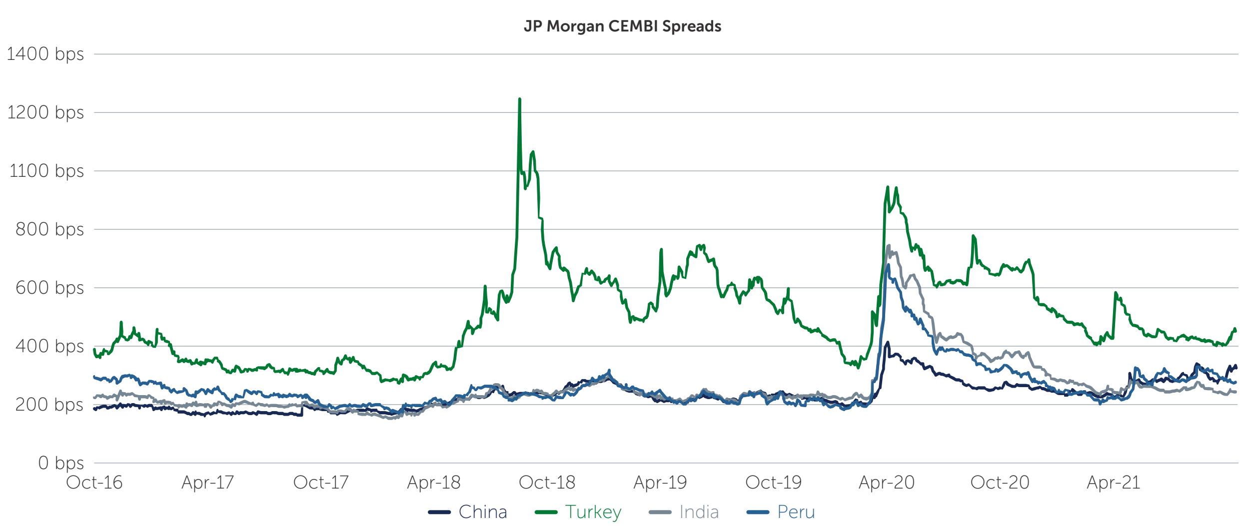
Taryn: For CLOs specifically, one near-term risk is the transition from LIBOR to SOFR. While the transition has been well-telegraphed, many of the specifics are still being worked out—such as the adjustment that's going to be assigned. And when you're buying CLO equity, for example, and you're 12.5x levered to the underlying loans, whether that adjustment ends up being zero, 10 bps or 26 bps will result in meaningfully different outcomes for your value proposition.

In terms of opportunities, I would point to two areas. The first is in BB CLO tranches, where there is significant manager tiering between deals that have the same structures and very similar risk dynamics. For investors that understand a manager's strategy, performance and philosophy, this dynamic has resulted in opportunities to add value by investing in managers that perhaps aren't as well received despite their positive performance. The second is CLO equity. If we start to see rates rise a bit, and all-in yields begin to look more attractive, that could drive AAAs tighter, which becomes increasingly interesting for CLO equity—which is currently trading in the context of mid double-digit expected returns.

Omotunde: For EM corporate debt, one of the biggest possible risks is a policy error on the part of the Chinese government. While the Chinese economy has the policy tools in place to deal with the change that is underway, if the government takes the changes too far—and causes a pronounced slowdown in the economy—it could create a significant headwind for the wider EM asset class. Outside of China, we'll also closely monitor geopolitical risks, including the elections in Brazil and tensions in places like the Middle East. Developments around COVID, too, will remain top of mind.

In terms of opportunities, we believe the high yield segment of the market looks quite attractive. While it's come in a bit, the spread differential between investment grade and high yield continues to look wide relative to the long-term average. Within the high yield segment, we have continued to see opportunities arise on the back of volatility in countries like Brazil, Ukraine and Turkey. Often, these pockets of volatility cause corporate spreads to widen beyond what fundamentals would suggest, creating opportunities to identify solid, globally diverse issuers at attractive prices.

Figure 4: High Yield Segment of EM Looks Attractive

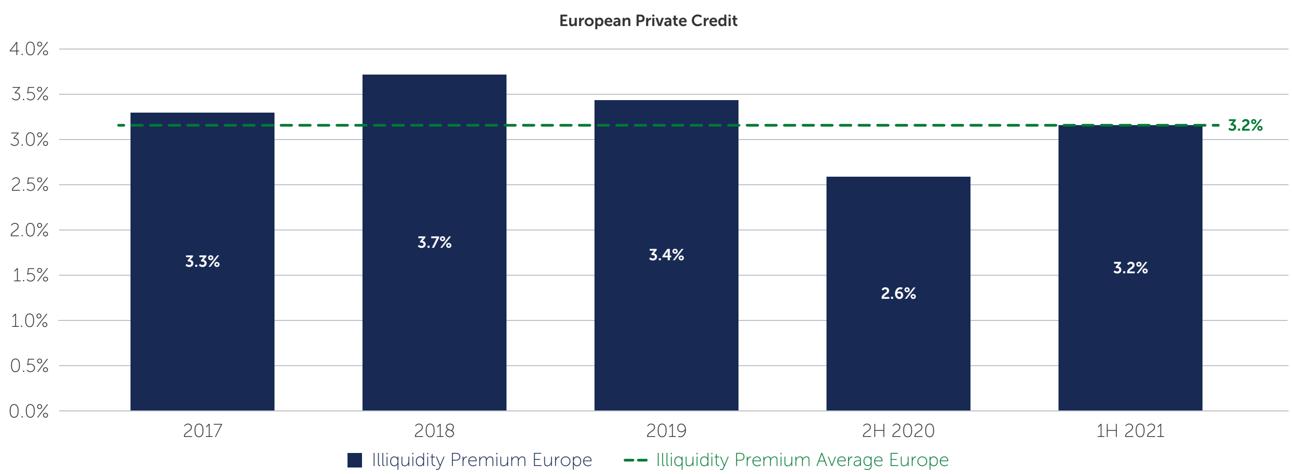


Source: J.P. Morgan. As of September 30, 2021.

Mark: For an illiquid private debt portfolio, your biggest risk is ultimately credit loss. For that reason, maintaining discipline when it comes to credit quality, particularly in such a competitive market, is absolutely key. This means maintaining access to deal flow, and ultimately selecting high-quality credits.

In terms of opportunities, there are three main factors driving growth in the market. The first is the continued movement away from traditional bank lending in the middle market, which has been spurred largely by regulatory pressure. The second factor is that direct lenders continue to increase their scale, which should continue to create growth in the marketplace. Finally, as mentioned earlier, private credit tends to be more insulated from the ups and downs of capital markets and capital flows. What drives our market is the dry powder held by private equity funds around the world, which is currently at all-time highs. Ultimately, that should continue to help power private equity-driven deal flow in the near to medium term.

Figure 5: A Consistent Illiquidity Premium



Source: Data represents 3-year discount margin (All-In Spread (DM-3) = [(fee/3) + spread + greater of floor or base rate) / (1 – fee)] - base rate) for both Barings and CS LL Index. As of June 30, 2021.

John: I share Taryn's opinion of risk around the LIBOR to SOFR transition, given that our market has a lot of floating rate assets. Another risk we're keeping an eye on is whether there is any mismatch today between market expectations for Fed movement in 2022, and what the Fed actually does—as we know, surprises can create problems in the market.

In terms of opportunities, I would first highlight that the potential illiquidity premiums on offer across private markets remain very attractive, in our view. More specifically, European direct lending comes to mind in particular. In the U.S. and globally, real estate debt and equity also look attractive. For high-grade fixed income investors specifically, we have also seen increasing interest in certain subsets of the private residential mortgage sector, particularly GNMA early buyout loans. But like Martin said, we see benefits of flexible mandates that look across asset classes—and that can include across public and private credit markets—which we believe can help investors capitalize on opportunities as they arise, through 2022 and beyond.

This piece was adapted from a virtual panel discussion. Listen to the podcast version here.*

*Full Podcast URL: https://www.barings.com/us/institutional/viewpoints/2022-public-private-credit-market-outlook

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