FROM THE
BOTTOM UP

CONVERSATIONS

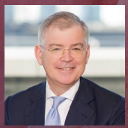
2023 OUTLOOK

PUBLIC & PRIVATE CREDIT MARKET OUTLOOK

In this roundtable discussion, our credit market experts across public and private markets describe how they're navigating today's more challenging backdrop and where they're turning to find strong, risk-adjusted returns.

SCOTT ROTH
Co-Head of U.S. High Yield

OMOTUNDE LAWAL
Head of Emerging Markets Corporate Debt



ADAM WHEELER
Co-Head of Global Private Finance

STUART MATHIESON
Head of Investments, Capital Solutions

BARINGS

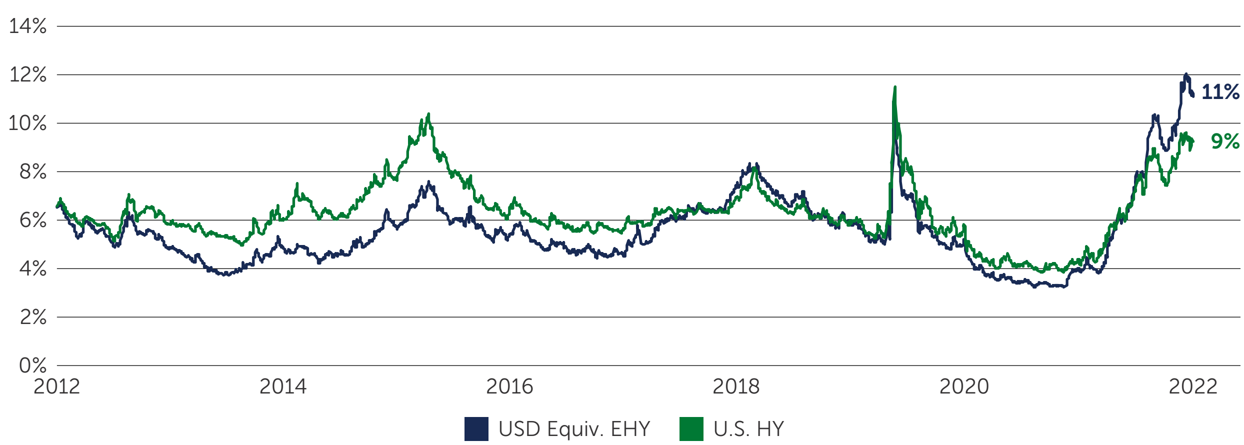
Scott, as it relates to high yield, do today's market valuations foreshadow what you believe to be a wave of defaults and credit losses—why or why not?

SCOTT ROTH: While fundamental headwinds are clearly building, we believe any potential rise in defaults may be far less significant than what markets are currently pricing in. In recent weeks, as an example, the implied default rate for the leveraged loan market has hovered around 6%—that's a lot of bad news priced in.[1] While defaults will likely increase going forward, we believe they may end up being much lower, perhaps closer to 3%, for a few reasons:

For one, after capital markets reopened in 2020, the bond and loan markets experienced a record amount of refinancing volume—by some estimates, north of a trillion dollars.[2] This has resulted in a much more manageable maturity schedule for companies, with only about 8% of the market expected to mature over the next two years. Additionally, the quality of the market has improved notably over the last decade, particularly on the bond side. BBs now account for 53% of the global high yield bond market, for instance, up from 38% in 2007; in the same period, the percentage of single-Bs has dropped to 36%. The European high yield market is even higher-quality—nearly 70% is BB, while only 5% is CCC.[3]

Interestingly, despite the higher quality of the European market, spreads in Europe are trading roughly 100 basis points (bps) wider than they are in the U.S. given the greater macro risks that exist. The dispersion in yields between the two markets is also as wide as it's been in recent history, with the U.S. bond market currently yielding roughly 9% and the European market, hedged to U.S. dollars, yielding closer to 11% (**Figure 1**). This dynamic has created interesting opportunities in so-called "reverse Yankees," or Euro-denominated bonds issued by U.S. companies—essentially, opportunities have emerged to sell U.S. dollar-denominated bonds of a global issuer, and then buy the exact same bonds, issued in Euros or Pounds, from the same issuer at wider spreads and higher U.S. dollar hedged equivalent yields. The fact that prices in the European market are also more steeply discounted versus the U.S., and given that it's about one year shorter in duration, also has interesting implications in terms of total return potential going forward.

Figure 1: YIELD DISPERSION BETWEEN THE U.S. AND EUROPE IS WIDE RELATIVE TO HISTORY



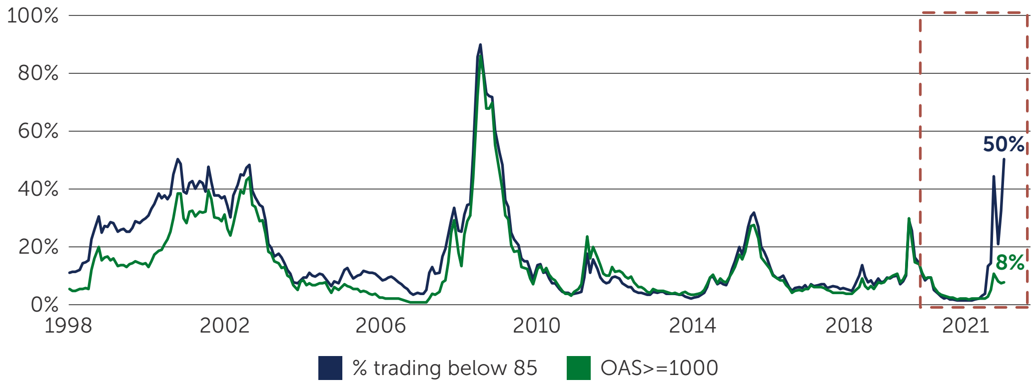
Sources: Bloomberg, Bank of America. As of October 31, 2022.

1. Based on Barings' market observations.
2. Source: Pitchbook LCD. As of October 31, 2022.
3. Source: Bank of America. As of October 31, 2022.

What is different about this interest rate hike cycle versus past cycles, as it relates to investing in high yield?

SCOTT ROTH: Given the magnitude of the rate increases we've seen this year, we are much more focused on managing rate risk, in addition to credit risk, than we have been in the past. Comparing the percentage of the market trading at distressed versus discounted levels underscores the impact that government rates have had. Today, roughly 50% of the global high yield market trading is at discounted prices of 85 or below, a significant increase since the beginning of the year. This compares to roughly 8% of the market trading at distressed levels, or wider than 1,000 bps (**Figure 2**). This divergence is notable because these measures have historically increased or decreased in tandem, suggesting the uptick in bonds trading at discounted prices is almost entirely driven by the rate market, rather than being credit-related. In our view, this dynamic suggests the strong potential for attractive total returns going forward.

Figure 2: INCREASE IN PERCENT OF MARKET TRADING AT A DISCOUNT IS ALMOST ENTIRELY RATE-DRIVEN



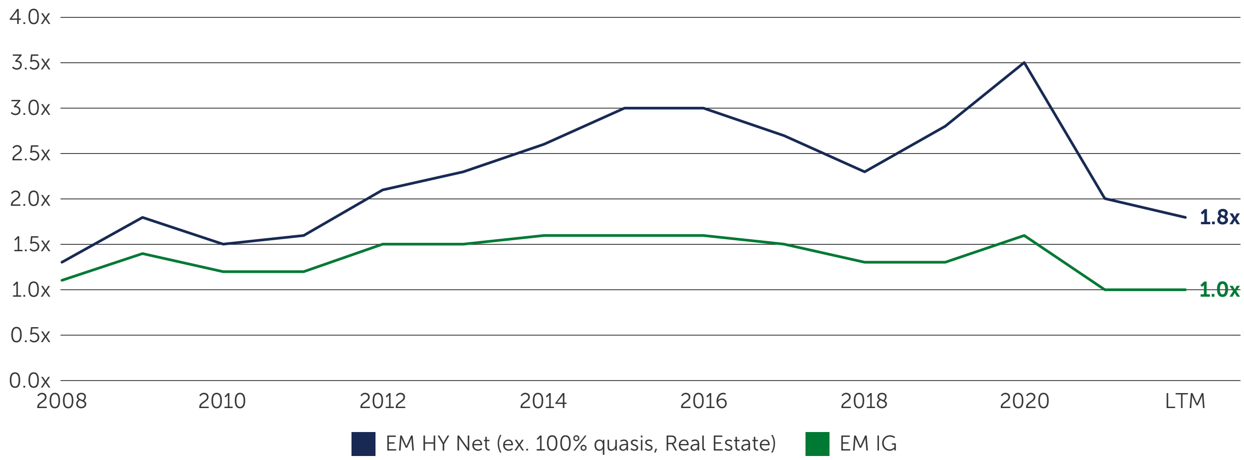
Source: Bank of America. As of September 30, 2022.

Tunde, how does the EM picture look, and what similarities or differences are you seeing relative to developed markets?

TUNDE LAWAL: Similar to developed markets, credit fundamentals across the EM corporate debt landscape have been quite resilient, even with the inflationary pressures at hand. Many corporates have been able to pass price increases through to consumers, and for that reason we have yet to see material deterioration in corporate balance sheets. While we will likely see some weakness in profit margins going forward, EM is coming from a strong starting point. Revenue and EBITDA are back to pre-pandemic levels for many issuers, and leverage remains in reasonable territory, around 1.8x for high yield companies and 1.0x for investment grade issuers (**Figure 3**). Additionally, while overall default rates are elevated, default rates excluding Russia, China and Ukraine have actually been in the low single digits,[4] and we expect them to remain around 2–3% going forward.

4. Source: J.P. Morgan Corporate Default Monitor. As of November 8, 2022.

Figure 3: EM CORPORATE NET LEVERAGE REMAINS IN REASONABLE TERRITORY



Source: Bank of America. As of September 30, 2022.

Given this healthy fundamental backdrop, and in light of the exogenous shocks that have rattled the asset class over the last 18 months, valuations look particularly interesting. In the high yield segment the market, for instance, spreads reached 720 bps in recent weeks, compared to a long-term average of 500-520 bps. This indicates just how much is priced in to the current market environment in terms of spread widening. It's a similar story on the investment grade side, where spreads recently reached 250 bps versus historical averages of about 180 bps.[5]

While past performance is no indication of future results, it is worth noting that when you look back at history, previous periods of significant drawdowns have been followed by attractive returns. Following the initial onset of COVID in 2020, EM corporate debt was down 17%; during the European sovereign debt crisis, the asset class was down 14%. Within 12 months from those periods, the asset class delivered double-digit returns, in some cases north of 20%.[6] We believe there is strong potential to see something similar going forward given that the average bond price within EM corporate debt is around 85 cents on the dollar.[7]

Adam, what are the key challenges facing the private credit market, and what dynamics are shaping middle market lending today?

ADAM WHEELER: One of the big questions today is how portfolios are holding up. While manager performance can look similar during the good times, I think what we're going to see over next year—as the challenges being discussed today materialize in private market portfolios—is much greater differentiation in performance. This is because no manager's portfolio is the same; every manager sources different assets, meaning no risk profiles look alike.

In terms of dynamics in the market, after Russia invaded Ukraine and the syndicated markets essentially shut down in terms of new issuance, private equity firms turned increasingly to direct lending to source debt for transactions. While pricing in the market did not move much initially, we are now seeing a real

5. Source: J.P. Morgan. As of October 31, 2022.
6. Source: J.P. Morgan. As of October 31, 2022.
7. Source: J.P. Morgan. As of October 31, 2022.

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One of the benefits of investing in private credit is the potential risk premium that stems from the illiquidity risk relative to liquid loans. But the steep price discounts in public markets today effectively show parity from a yield perspective between public and private assets. Why would an investor choose to allocate to private credit today instead of waiting until that dynamic reverts?

ADAM WHEELER: Private credit managers build portfolios over time, with the goal of delivering a consistent return through economic cycles. Ultimately, the way to do that is by avoiding losing capital. This asset class is driven by fundamental performance rather than by technical factors like you see in public markets. And again, what is happening now in the private market is that pricing, leverage and terms are improving, and we are seeing stronger covenant packages in loan documents. We believe these conditions will persist over the tenure of all the transactions we’re investing in, suggesting we may be setting ourselves up for outperformance over the next one to three years.

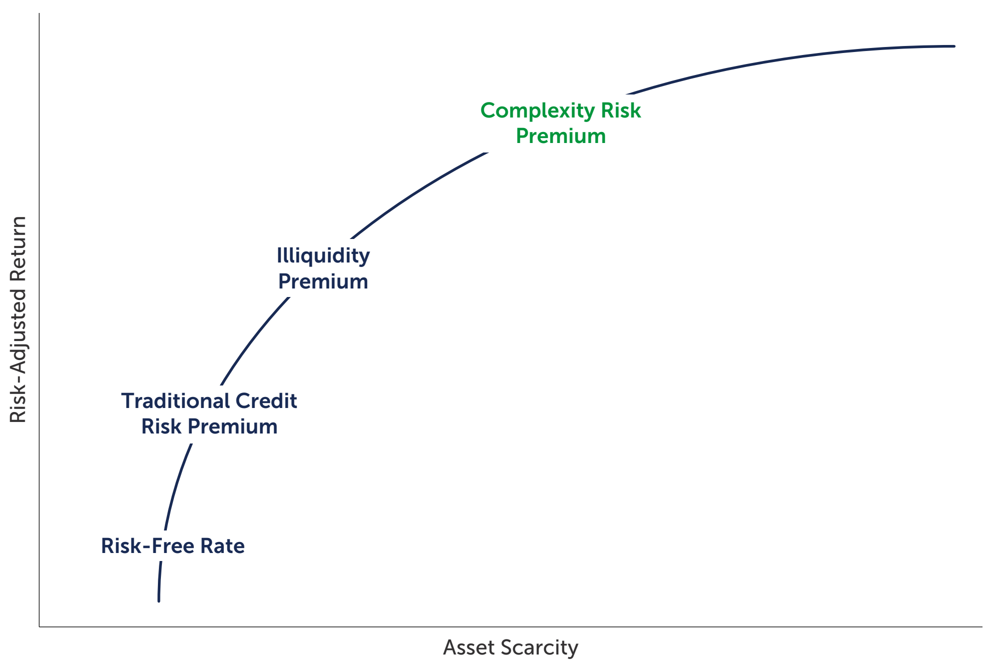
It is also worth noting that private credit is different than public markets in that loans cannot be traded on an exchange or sourced from one or two central locations. Rather, most transactions in this space are sourced through private equity sponsors and negotiated directly with the sponsor or issuing company. For this reason, having a strong origination or sourcing platform is critical to gaining access to the most attractive deal flow and then converting those opportunities into investments. This is also a buy-and-hold asset class, meaning there is limited to no ability to sell out of a position. For these reasons, we focus on investing in companies that we believe have a reason to exist through all parts of a cycle, and we take a fairly conservative approach to deploying capital. We build portfolios on a deal-by-deal basis, which means we can also be highly diversified.

Stuart, can you tell us how the opportunity set in distressed debt, and more broadly in opportunistic credit transactions, has changed relative to the last cycle?

STUART MATHIESON: Our focus and strategy in capital solutions—which captures opportunistic credit and special situations—has evolved significantly over the last couple of years, and goes beyond just buying discounted opportunities in the secondary public markets. This shift is due in part to the prolonged period of low default rates, but also stems from the fact that documentation is more accommodating than it has been historically. These dynamics have combined to present opportunities to look at different ways of bringing capital to companies, such as through providing basket or subsidiary financing.

The growth in the private finance market is interesting, as an example. As Adam said, portfolio performance will be based on what has happened over the last couple of years. Given the growth in the market, there are certainly going to be situations where investments do not work as well as managers may have hoped. In some cases, we may see an inability or unwillingness to hold and support companies through those types of changing situations. These scenarios can present opportunities for managers like us, who have the ability to engage and transact in a different way, to step in. Going forward, we expect opportunities like this to emerge across the entire corporate credit space, whether you're looking at public or private markets. Beyond the corporate credit platform, our team also leverages Barings' wider sourcing framework, having recently found attractive opportunities in areas like pharmaceutical royalties.

Figure 4: THE COMPLEXITY RISK PREMIUM IN CONTEXT



Source: Barings

Can you define the complexity premium potentially on offer in this space, and describe the skillset that managers need in order to effectively capture it?

STUART MATHIESON: The complexity premium in this space stems from the fact that you need to be creative in how you find solutions, and more specifically in how you source and structure deals. What we are essentially doing is looking at complex situations, digging in on diligence, and then negotiating and structuring solutions, which are tailored for each investment. Importantly, we look to work with businesses that we feel we understand very well from a fundamental standpoint—and where the 'complexity premium' enables us to then position ourselves to generate outsized returns.

Scott, looking ahead to the coming months and year, how will the interest rate environment shape your market and impact your investment decisions?

SCOTT ROTH: Where we are going is closely tied with where we have been. Over the last few years, we have seen 0% or negative interest rate policies, and trillions of dollars of negative-yielding debt. While this cheap money has been a golden era of sorts for private equity, that model may be a bit more challenged going forward, in terms of returns. If you look at the private credit deals that Adam referenced, for instance, the terms are different. In many cases, private equity will have to put more equity in, which will likely lower their returns.

Additionally, while it appears we are in the midst of a regime change in rates, the bigger question may be whether policymakers can extract themselves from policies of the past. Can we make the transition from QE to QT? To the extent we can, it should make a strong case for credit versus equity—or, at the very least, the discussion should become far more balanced than it's been recently.

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Tunde, do you believe today's market environment has fueled mass speculation? And looking forward, where would you choose to allocate capital?

TUNDE LAWAL: I agree with what Scott said regarding the moral hazard of central banks constantly bailing out the markets. And, unfortunately, we are now headed into an era where high tides will no longer lift all boats. When rates were at or below 2%, if you made an error and picked a wrong credit, it was a relatively inexpensive error to make. But with higher rates come higher stakes, which means that as a manager, it is imperative to do the credit work and truly understand the credit risk you are taking.

In terms of where we would put money to work, one country that stands out is Mexico, given that it stands to be one of the key beneficiaries of the near-shoring phenomenon that has begun playing out in the aftermath of COVID. Specifically, in Mexico today, there is a lot of real estate and land being purchased in the northern part of the country to build new plants and facilities. And while these greenfield sites take several years to come through, longer-term, we would expect to see the second and third-order effects of job creation and growth.

Adam, if you think of the cataclysmic change in rates from a year ago to today, which has had significant implications for borrowers, what's the smartest way to approach the private credit market today?

ADAM WHEELER: One dynamic that looks likely to unfold is a transfer of return from private equity to credit as we start to see underperformance from private equity. Private credit should benefit from rising base rates, but as Tunde said, the key will still be asset selection and avoiding losses. The next four to eight months are going to be interesting—it will be a difficult external environment, likely characterized by softening demand, eroding margins, less cash flow, and less serviceability. In our view, this sets the stage for a reset in multiples of businesses from an equity perspective, which we have not yet seen.

That said, we expect many private equity firms to provide capital support to their transactions, their businesses. But managers also need to be in the position of picking the right businesses—and they need to be willing and able to take ownership of those businesses if they underperform, manage them through their challenges, and ultimately sell them to get a recovery.

Stuart, as this cycle plays through, where do you believe the most lucrative opportunities are going to be, and how do investors position themselves now to capitalize on what we know is headed our way?

STUART MATHIESON: From a capital solutions perspective, one area I would highlight is providing the financing for liability management purposes, or stressed and situational refinancing. Our team is also looking for opportunities that stem from the dislocation in public markets, not at the index level but on an individual name basis. While this type of approach requires caution and patience, we believe there will be attractive potential returns on offer. With that in mind, my advice for investors over the coming months would be to position themselves alongside flexible capital, operating models that they trust, and with managers who have deep teams and the ability to quickly and efficiently execute.

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