Market Insights
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The Big Mac on Private Assets

The Revenge of Public Fixed Income

Author

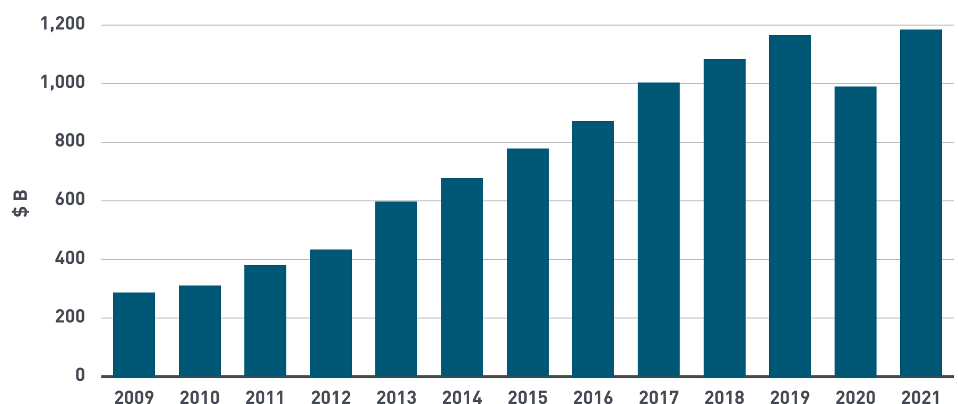
Benoit Anne
Managing Director
Investment Solutions Group

Private debt has grown substantially as an asset class over the past decade. There are many factors that contributed to this growth, but the most compelling was the abnormally low level of yields offered by public fixed income markets at the time. Investors went on a hunt for yield, and in doing so, helped promote the take-off of private debt. But the yield environment has changed dramatically, and we now believe public fixed income is back as an attractive alternative to private credit.

The 2010s was the golden decade of private debt. But first, what is private debt or private credit? Private credit investments have no readily tradeable market and therefore no quoted market price. Typically, private debt is provided by non-bank entities to fund small and middle-market companies. There is a wide range of private credit strategies, including direct lending, distressed credit, mezzanine debt or special situations, among others.

Private debt really took off as an asset class following the global financial crisis. Indeed, the AUM of private debt grew by a remarkable 12.5% every year on average from 2009 onward to reach $1.2 trillion by 2021 (Exhibit 1). The stars were aligned. Several rounds of quantitative easing by the US Federal Reserve and other central banks led to major yield compression in global fixed income. This, combined with falling credit spreads following the economic recovery left investors scrambling for yield, which they found in private credit. The strong appetite for private debt was also made possible by the tightening of financial regulation in the aftermath of the financial crisis, which caused banks to de-lever and rebuild their capital buffers, at the expense of traditional lending activities.

Exhibit 1: The Growth of Private Debt AUM



Source: Preqin, Global Report, Private Debt, 2022.

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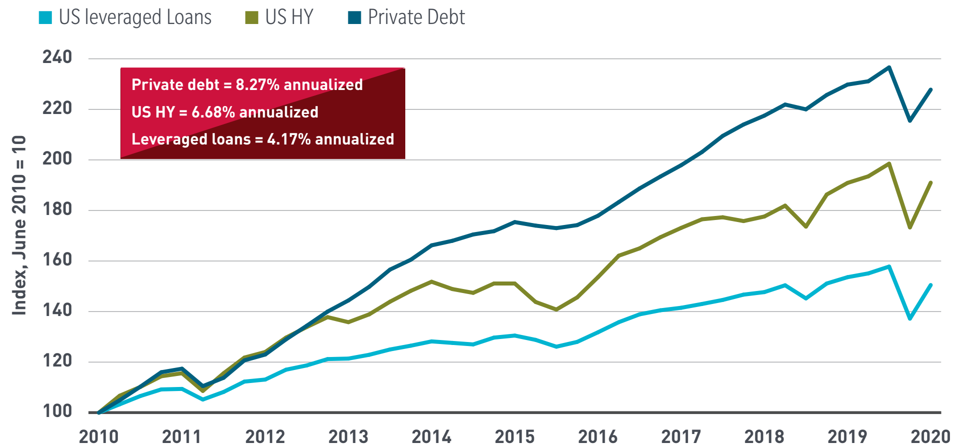
Private debt produced relatively strong returns over the past decade. Looking at historical data, the performance of private debt exceeded that of publicly traded high yield and leveraged loans (Exhibit 2). From June 2010 to June 2020, private debt produced returns of 8.27% on an annualised average basis, or some 1.6% higher than traditional high yield. The outperformance was particularly noticeable during the period 2013 to 2018 when public fixed income yields were fairly depressed.

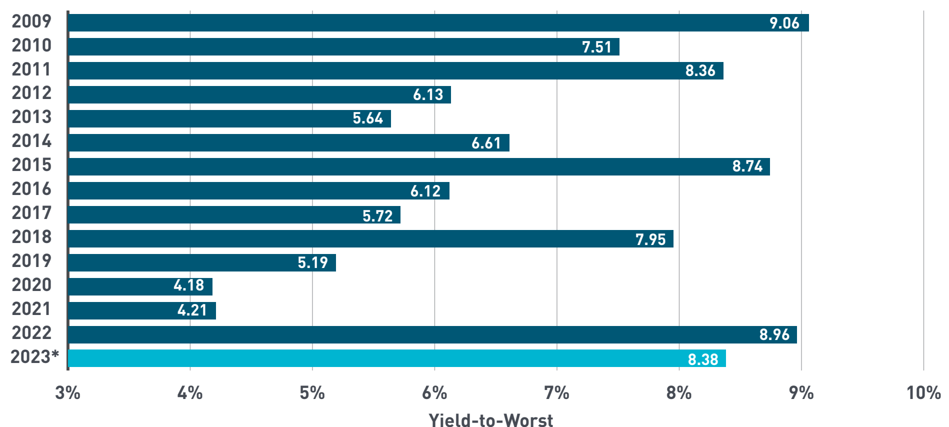
Exhibit 2: Historical Returns: Private Debt vs. Public Fixed Income



Source: Burgiss, Bloomberg, Morningstar. Private debt = US private debt returns, all funds. Quarterly data from June 2010 to June 2020. US HY = Bloomberg US Corporate HY index. Leveraged loans = Morningstar LSTA US Leveraged Loan index.

We believe that the tide for private debt has turned however, with public fixed income now offering an attractive — and less risky — alternative. For a start, valuation has been restored for fixed income in a dramatic way, compliments of the severe correction in rates over the past few quarters. At this juncture, US high yield produces all-in yields in the region of 8.5%, which constitutes a very attractive level by historical standards (Exhibit 3). In fact, the percentile rank of US HY yields over the past ten years stands at 92.2%, indicating that yields have historically been higher than they currently are only 7.8% of the time.[1] In other words, investors on the hunt for yield can now do so in the public markets.

Exhibit 3: Year-end Yields for US High Yield

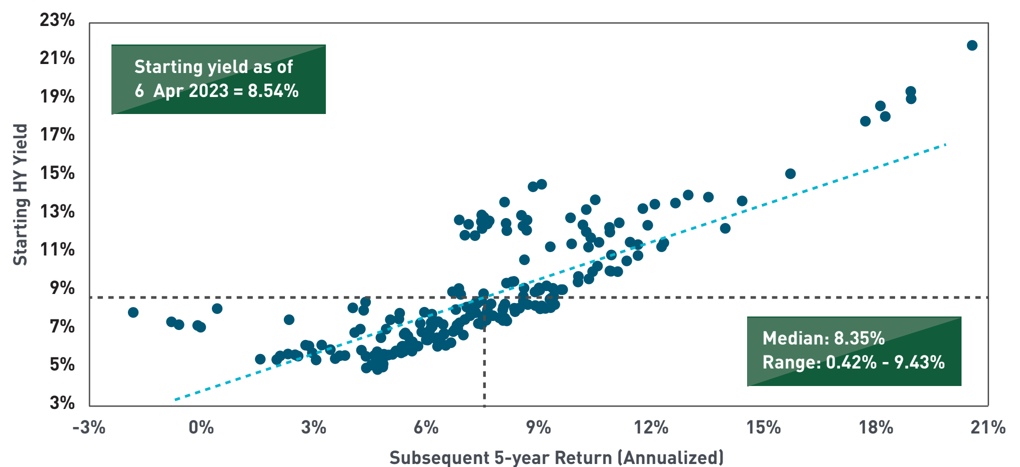


Source: Bloomberg. Bloomberg US Corporate High Yield Yield-To-Worst. Annual data. *Data for 2023 is as of 6 April.

This is an important development given the way fixed income returns are derived. The starting yield for fixed income as the key driver of income returns, the most stable and predictable component of total return, is likely to have a major influence on future returns. Looking at historical data, current yields were in the past associated with subsequent 5-year median returns of 8.35%, and with a range of 0.42% to 9.43% (Exhibit 4). This suggests returns that are broadly comparable to the returns of private debt during its golden decade.

Looking ahead, we believe that the ability of private debt to outperform traditional high yield in a substantial way has been greatly diminished by what we call the great valuation reset of fixed income. This, in turn, would suggest a sharply reduced illiquidity premium, *i.e.* the premia private debt offers investors to compensate for the illiquidity of the asset class.

Exhibit 4: US HY, Starting Yield and Subsequent 5-Year Return

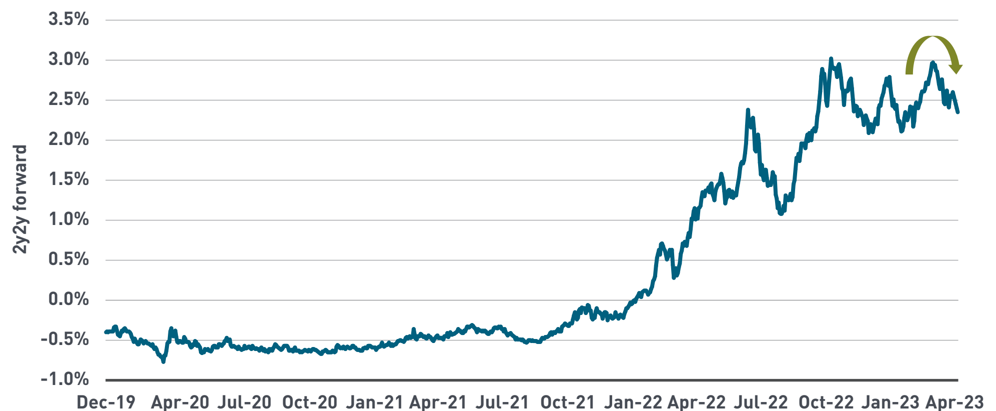


Source: Bloomberg. Monthly data from January 2000 through March 2023. Range is defined as +/- 30 bps around current yield. US HY is represented by the Bloomberg US High Yield Bond Index.

The floating rate exposure associated with private debt is no longer an attractive feature, in our view. It is well established that a substantial share of private debt deals is based on floating rates. When rates were correcting higher in the face of rising inflation risks, the floating rate feature was an important component of the appeal of private debt. But we believe that this is no longer the case given where we are in the rate cycle. Most central banks have now completed — or are about to complete — their tightening cycle. The risk to market rates is no longer skewed to the upside following the recent correction. Likewise, there is less value in the inflation hedge characteristics of a floating rate instrument now that inflation dynamics have improved.

Specifically, inflation appears to have peaked in many markets including the US, and we believe that disinflationary forces are now well established because of aggressive monetary policy tightening. At this juncture, the case for establishing longer-duration exposures is stronger as opposed to floating rates. When looking at US 2-year forward rates, currently trading at 2.35% versus 4% for the spot 2-year rates, it is clear the market now anticipates rates will correct lower in the period ahead (Exhibit 5).

Exhibit 5: Market Rates Are Priced to Decline Going Forward



Sources: Bloomberg. 2-year, 2-year forward rates, illustrating the market pricing of 2-year rates in 2 years' time. Daily data as of 6 April 2023.

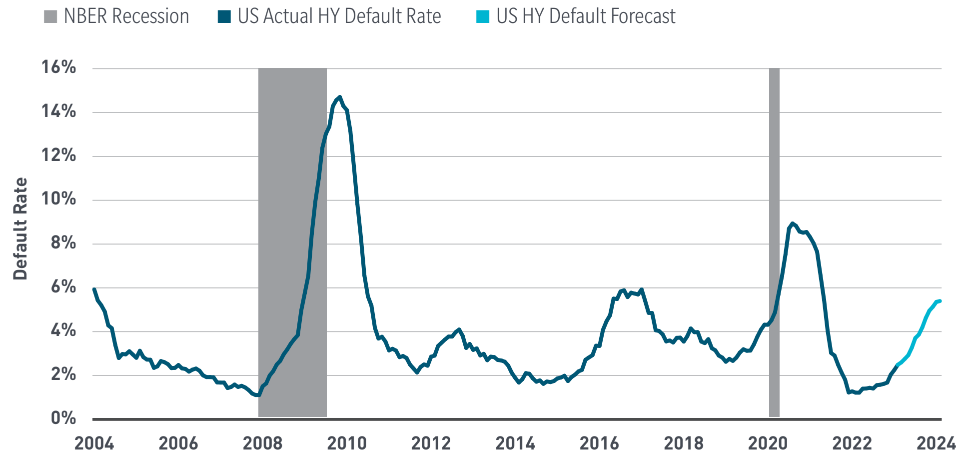
The recent focus on liquidity risk is likely to undermine the appeal of private debt going forward. Private debt is considerably less liquid than public fixed income given it is not tradable through conventional means and is far less transparent than public debt. The 2022 UK pension crisis and the banking stress in the United States and Europe in March 2023 have been stark reminders that sound liquidity risk management is an important pillar of any investment process.

In other words, liquidity management is now top-of-mind for global investors. In extreme market situations, the cost of giving up portfolio liquidity can become very difficult to manage. By choosing to allocate to private debt, investors make that choice of forgoing some portfolio liquidity. With that in mind, we believe that an overweight allocation to private debt may become harder to justify, especially for investors with significant liquidity needs. In contrast, public fixed income offers a much better alternative when it comes to maintaining adequate portfolio liquidity.

The higher credit risk attached to private debt may be difficult to justify in the face of rising recession risks. Private debt typically encompasses higher credit risk inherent in small and midsize companies. In addition, it also tends to involve higher leverage and greater structural complexity, which makes the risks harder to evaluate. These factors overall could represent a serious challenge for private credit, in our view, especially as we are facing the threat of a recession.

Given the recent macro volatility, it has become particularly difficult for investors to assess macro risks. While it is true that defaults are also bound to rise in publicly traded high-yield bonds, the outlook for HY default risk for now remains fairly benign. For a start, current default rates continue to be quite low, given where we are in the business cycle. Moody's estimates the trailing default rates at 2.5% and at 2.2%, for the US and Europe respectively. Using Moody's baseline scenario, which appears reasonable to us, the default rates would rise to just 5.4% over the next 12 months in the US and to only 3.9% in Europe (Exhibit 6).[2] In other words, default rates are not expected to rise to levels typically associated with recessions.

Exhibit 6: US HY Default Rates and Default Forecasts



Source: Moodys' Investors Service, NBER. Monthly Default Report, February 2023. Forecasts up to February 2024 based on Moody's baseline scenario. Grey bars indicate NBER recessions. No forecasts can be guaranteed.

Public fixed income is back, including as an attractive alternative to private debt. The valuation backdrop of public fixed income is now compelling with the compression of the so-called illiquidity premium for private debt. In addition, many of the features of private credit that were attractive in the past are now being challenged, especially the higher credit risk and its predominant floating rate characteristics.

Endnotes

[1] Source: Bloomberg. Daily data from 7 April 2013 to 6 April 2023. US HY = Bloomberg US Corporate High Yield Index.

[2] Moody's Investors Service. Monthly Default Report. As at February 2023.

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