A bright outlook for corporate credit

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Recent shocks to the banking sector indicate that central banks' efforts to tame inflation are having an intensifying effect, with broader economic consequences likely to follow. We see three key economic themes over the next six to 12 months that should be on pension funds' radar.

Firstly, bank failures and the rising cost of capital have raised the prospect of a significant tightening of credit conditions, and therefore the risk of a sooner and deeper recession in the US – and this could act as yet another headwind that could very well pull Europe into recession as well.

Central banks are likely near the end of their hiking paths, but not tightening further is different from normalising or even easing policy, which will likely require inflation falling towards target levels. Finally, recessionary risks and any further bank stress are unlikely to be met with another large fiscal response unless the economic implications are clear and severe.

This economic backdrop will pose challenges and opportunities for pension schemes attempting to navigate the changing landscape, as both public and private markets adjust to the heightened volatility. In our view, opportunistic corporate credit is one area that could benefit, as highly-leveraged borrowers adapt to the new world of higher interest rates.

The corporate debt backdrop

In past cycles, junior high yield debt and securitised mortgage holdings were stress points, with these areas of corporate debt encountering issues ahead of other areas. Today the challenges are coming from the unprecedented volume of senior loans issued over the last decade in the public leveraged loan market (such as syndicated bank loans to large companies) and in the new private senior lending space (loans issued by investment funds to smaller companies). Together, these loans account for essentially all sub-investment-grade net issuance over the last seven years.

But the private segment of the market has grown rapidly since the global financial crisis – when large commercial banks stepped away from lending to small and mid-size companies – and now rivals the public loan market in annual issuance. We believe private loans will be a growing source of stress – and opportunity.

Highly-leveraged borrowers in the private loans space are more vulnerable to economic downturns. Many are smaller companies that have narrow business strategies, less-resourced management teams, high leverage relative to assets, and little access to the broader capital markets. In the US and Europe, with central banks raising interest rates and with a recession looming, these borrowers now face both sharply rising debt service costs and earnings headwinds.

Credit risk in these senior loans is further heightened by issuers' weak investor covenants. Amid the last several years of historically low interest rates, investors poured capital into both public and private markets, leading lenders to compete and issue deals with some of the highest leverage in history – often anticipating big future cost savings – alongside weakened covenants.

But not every corporate credit issue suffers weak fundamentals, and some areas of the market look reasonably healthy in our view. These include many areas of the high yield bond market, particularly larger issues rated BB or B that have weathered multiple cycles. We think these borrowers' high yield ratings are appropriate for their balance sheets, but they could still be fairly resilient. There's been very little net issuance in the high yield market in the last several years, which also should help support prices.

Fresh capital

In crisis comes opportunity. The pullback by traditional lenders is creating very attractive opportunities for new entrants with fresh capital to demand wider lending spreads and better-structured deals with more downside risk mitigation and less reliance on leverage. Yields have climbed to enticing levels and the risk-adjusted return profile has considerably improved from just nine months ago.

With private direct lending firms, syndicated bank loan markets, and commercial banks now all quite constrained, borrowers are increasingly seeking private capital solutions transactions. These bespoke one-stop financings can provide more flexible capital to borrowers with customised terms and structures. We therefore believe demand for bespoke capital solutions will mushroom over the next several years as borrowers face increasingly acute liquidity needs and the lending environment becomes challenged.

As a result, we see opportunities to provide liquidity across the middle market to performing companies that face challenges funding working capital needs, closing on acquisition targets, or refinancing existing debt maturities. We also think the landscape of opportunities will get more attractive with increased maturities in 2025 and 2026, and as higher-than-expected financing costs and earnings headwinds drain liquidity.

Finally, we expect to see private debt funds and banks seeking to sell private loans held in their portfolios. Private debt funds will likely face curtailed lending from banks, forcing them to improve their overall credit quality and sell weaker positions. Similarly, banks are likely to continue reducing their illiquid exposure on their balance sheets and pivot to higher-liquidity assets.

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PIMCO is ideally situated to be a buyer of these assets as our broad industry research coverage, deep capital and ability to act rapidly makes us an ideal buyer. As we evaluate the market, we see a meaningful mismatch in the supply of private capital to address these opportunities. According to industry sources, only approximately $200 billion of capital was available for more bespoke private capital solutions financings at year-end. As a result, we expect strong return opportunities for managers with clean balance sheets to provide liquidity to these vehicles.

Plugging the gaps in European capital markets

Traditional markets for public and private loans are largely shut and liquidity remains thin. Against this backdrop, European capital markets present an interesting set of opportunities. The energy crisis and the war in Ukraine have put Europe under greater economic stress. Similar to the US, core inflation in Europe remains elevated, yet interest rates are lower, leaving the European Central Bank (ECB) to confront a steeper tightening curve as it has moved off negative interest rates.

We believe the steep tightening cycle will remain particularly challenging for European credit markets: It has sapped investor demand and, in turn, public credit issuance fell more than 70% in 2022. As in the US, the collapse in investor appetite has left banks saddled with billions of dollars of hung deals where funding was committed to borrowers but the banks were unable to place the debt.

As investors and banks retreat and spreads widen, we see opportunities for investors with fresh capital to plug the liquidity gap. Yet investors need to be quite selective and mindful of the vagaries of Europe's restructuring laws. An on-the-ground broad, highly experienced restructuring team is critical in our view, with the resources and networks to bring a restructuring either through the courts or through an out-of-court consensual agreement.

Where does that leave private equity?

A primary source of private equity returns over the past decade has come from leverage and its declining cost. Alongside falling interest rates, private equity benefited from steady corporate earnings growth and a buoyant equity market, where exit valuation multiples for asset sales were consistently higher than the initial purchase multiples. Looking forward, we think earnings growth will

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likely remain challenged, specifically in some of the high growth sectors that private equity has been favoring in recent years, including healthcare and technology. Finally, traditional leverage is less available now and considerably more expensive than it has been, creating headwinds for private equity performance.

Over the next several years, we believe the median returns for opportunistic credit investors will be similar to those in traditional private equity but with lower volatility and improved risk profile. And should we enter a more prolonged distressed period, opportunistic credit returns for managers skilled in restructurings could be quite favorable, as they should be able to buy at a material discount to par.

More broadly, slowing M&A activity, weak valuations, and rising interest rates are material headwinds to traditional private equity in our view – both in terms of putting capital to work and attractive realisations at the back end. To be sure, we have evaluated the significant dispersion in private equity fund returns and see possibilities for materially lower returns in the current vintages.

In contrast, opportunistic credit benefits from collateral and is less dependent on multiple expansion or earnings growth. Returns are expected to mostly materialise in the form of coupons and cash payments, and benefit from debt maturities which can create a shorter weighted-average life for capital deployment – all of which seem like a defensive way to invest in this environment.