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SVP Market Update: Tough Times Ahead

By Victor Khosla | February 16, 2023

2022 was a grinding year in the markets. The Fed and the ECB hiked rates hard to counter inflation, the Ukraine war unsettled some well-established markets, and a rapid decline in US-China relations all ushered in a new era in global financial markets. US and European GDP growth decelerated from the post-COVID stimulus sugar high, with the US down from +5.9% in 2021 to +2.1% in 2022, while Europe went from +5.3% in 2021 to +3.3% in 2022 with the biggest economy Germany lagging at +1.9% in 2022.[1] The year ended with widespread losses across both rates and equities, with for example 10-year Treasuries down -16.2%, US high yield down -11.2% and US equity markets down -18.1%.[2] The year was punctuated by short fierce rallies in July and November—and once again in early 2023 at the time of this writing.

The markets are grappling with a lot of uncertainty about the path forward. On one hand, the central banks on both sides of the Atlantic are talking tough about continuing to raise interest rates and forward-looking indicators like the purchasing manager indices (PMIs) and consumer confidence are pointing to a recession in the US and Europe. At the same time, winter has been milder taking the worst-case scenario off the table in Europe at least for now, China has opened back up hard—good news for the global economy—and there is an entrenched belief in some parts of the market that the Fed will start to even decrease rates as we get to the end of 2023.

In our view, while the exact path forward is hard to read (shallow recession, deep recession, perhaps a soft landing), we are now sentenced to operating in a different world than the one we have operated in since much of the 1990s. The US Federal Reserve has twin goals, unemployment and inflation, and for the first time in decades is fighting inflation. It is no longer the "friend" of the markets with the automatic response with lower rates to counter recessions—at least so long as inflation is running loose. At the same time, China has been a growth engine for the global economy, and with the increasingly rancorous split with the US, the global economy has lost some of its engine (at least until we find a new one). **As a result, we expect a messy few years in the markets as we transition to a new normal.**

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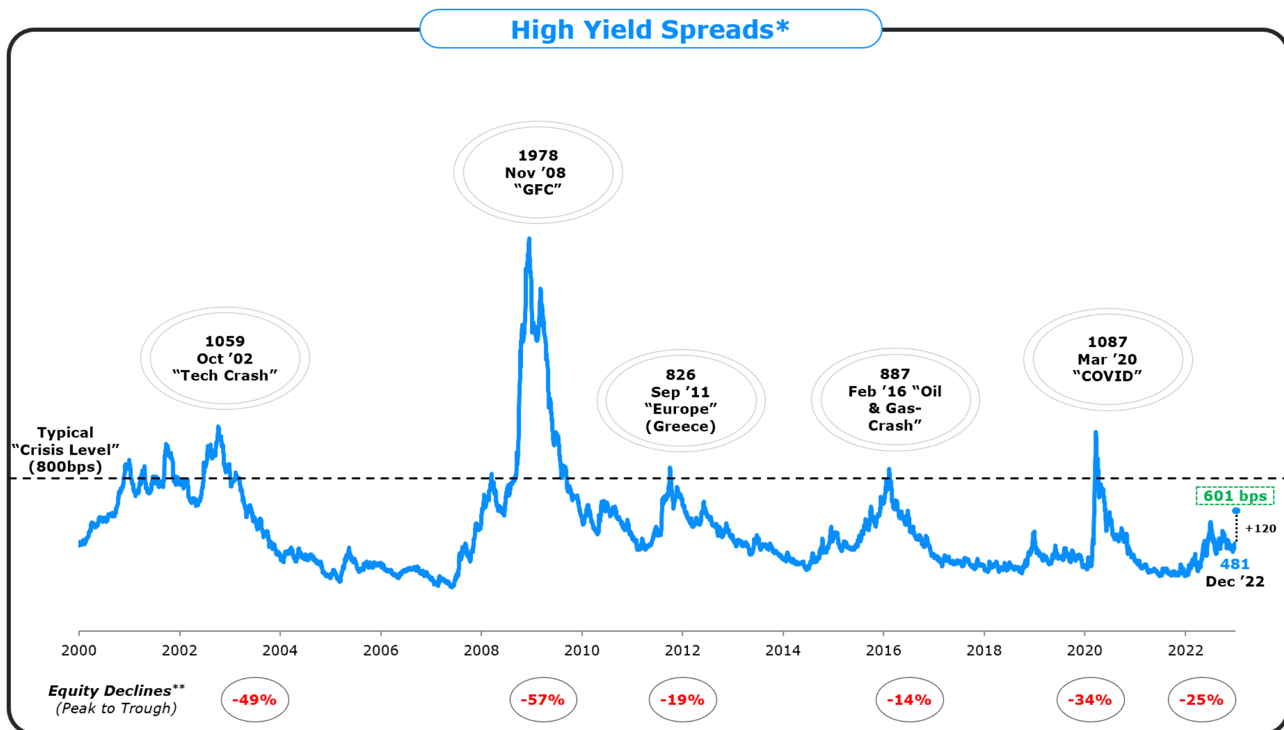
All this grinding has also played out in the credit and distressed markets. High yield spreads have yo-yoed through all of 2022 and stood at 481 basis points at the end of the year from a high of 599 basis points reached in July.[3]

We typically have set 800 basis points as the dividing line signaling a crisis, and measured this way, we have so far not breached the barrier; however, as we look deeper at the data, we believe we have come very close to such conditions. The quality of high yield debt is much superior today compared to past decades—it has more higher rated BB debt (over 40% more than in 2000), plus more secured debt—and trading at 90 cents today (rather than par or 100 cents) offers lower losses in the event of a default.[4]

As a result of this higher quality, and the impact of higher rates on bond prices, we estimate that on an apples-to-apples basis, spreads today would be around 120 basis points higher[5] in a comparison with previous cycles, so spreads of approx. 480 basis points at year-end 2022 would be comparable to say 600 basis points over the past two decades.



**Source: BAML. Chart represents BAML US High Yield spread to US Treasuries from January 2000 through December 31, 2022.*
***Source: Bloomberg. Peak to trough drawdown % changes for S&P 500 Index based on daily close prices.*

All data as of December 31, 2022 unless otherwise indicated, and figures are rounded for ease of presentation. Past performance is not indicative of future results. Projected financial information and other forward looking statements do not constitute, nor are intended to constitute, a promise of actual results.

You get a glimpse of all this when you look at the absolute level of high yield prices; about 20.4% of the high yield universe is trading at prices below 80 cents of face, much more comparable to the high of 25-30% we have seen in previous cycles (with the exception of the GFC in 2008)[6].

Furthermore, the picture looks significantly different in the loan market where we buy much of our debt. There, the credit quality has deteriorated materially—70% of the US leveraged loan index is now rated B or below, compared with 51% of the High Yield bond index.[7] As many of these overleveraged companies face substantially higher interest costs and relatively near-term maturities on their debt, we see the number of restructurings increasing considerably.

As a result, our pipeline of curated deals has grown by leaps and bounds over the course of 2022. At the start of 2022, we were focused on about 20 new deals mostly in the US and Europe. By the end of the year, our pipeline had grown to about 100 deals with approximately $250 billion face amount of debt.[8] For the first time in a while, it was more European heavy, approximately 60 deals with about $112 billion face amount of debt—as the European economy slowed much faster than the US.

So, overall, while the economic path forward is foggy, we believe we have messy and tough times ahead in the high yield and leveraged loan markets. In our view, we believe it is creating the most compelling (and longest lasting) opportunity for what we do for a living since the GFC of 2008, and we plan to lean in and take advantage of it.

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Letter Endnotes

[1] Real GDP growth rates. Sources: Bureau of Economic Analysis for US; Eurostat for Eurozone and Germany. European GDP for 2022 incorporates Bloomberg consensus for Q4.

[2] In order, these refer to (a) the total return for 2022 on the Treasury Note that was then-current 10Y bond at the start of the year; (b) 2022 full year returns for ICE BofA US High Yield Index ("H0A0 Index" on Bloomberg) and (c) 2022 full year return for the S&P 500 Total Return Index ("SPXT Index" on Bloomberg).

[3] "Govt OAS" for ICE BofA US High Yield Index ("H0A0 Index" on Bloomberg).

[4] Based on SVP analysis of the ICE BofA High Yield Index.

[5] Based on SVP estimates of expected loss given default that account for the impact of (a) the ratings mix of the constituents of the ICE BOFA US High Yield Index; (b) Moody's estimated default probabilities and recovery rates; (c) the secured/unsecured debt split in the ICE BOFA US High Yield Index; and (d) the prevailing absolute level of bond prices at a given OAS level. SVP estimates are compared against average levels of the aforementioned categories over the period between October 31, 2002 through December 31, 2022, do not reflect the actual level of credit spreads as of December 31, 2022, and are presented for illustrative purposes only. The factors used to calculate these estimates has been selected by SVP in its judgement, and do not reflect all factors that may impact the level of high yield spreads, including, but not limited to, investor flows or other technical factors. Were factors and/or sources of estimated default probabilities and recovery rates selected by another party, the information presented herein may be materially different. **Past performance is not necessarily indicative of future results.** Additional information regarding the calculations presented herein is available upon request.

[6] Refers to the % of total par value in the ICE BofA US High Yield Index that is trading under 80₵. While this number ended the year at 20.4%, its peak for 2022 was 31.9% on Sep 29th.

[7] Leveraged loan data is from LCD as of 1/31/2023, High Yield data is for the ICE BOFA US High Yield Index as of 2/9/23.

[8] There is no guarantee that SVP or any SVP fund will pursue or consummate any of the opportunities in the target pipeline.

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