the art of boring™

EP 181 | Credit Markets: Risks, Rewards, and the Road Ahead

[00:00] Kevin Minas: On this episode of The Art of Boring, I sit down with Brian Carney, lead portfolio manager of the Mawer Global Credit Opportunities strategy. We start our conversation with a review of what moved credit markets to close out the year. We also discussed the current state of default rates in the high-yield market, what the team's seeing in the CLO [Collateralized Loan Obligation] space, as well as the recent trend of big banks reasserting themselves in the below investment grade lending space. Brian shares his rationale for why reaching for yield can be so tempting for investors, but also why it can be so harmful to long-term investment success. And we close out with Brian's reflections on the first year of Mawer managing the global credit opportunity strategy.

[00:46] Disclaimer: This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.

[00:01:03] Kevin Minas: Brian, welcome back to the podcast.

[00:01:05] Brian Carney: Thanks for having me back, Kevin. Good to see you.

[00:01:07] Kevin Minas: Nice to see you as well. As always, let's start with an update on the markets. Q4, if you can give us the notable developments for the quarter, as well as just if you have thoughts on how the year went as well.

[00:01:18] Brian Carney: We spoke about three months ago and for me personally, it kind of feels like the world has turned upside down or maybe even worse since then. And I’ve got to tell you, there are mornings I don't feel like getting out of bed and I don't even have any social media, Kevin. People with social media, I don't know how they do it. But my focus is investing in credit markets, which is why you're having me back. I'm not an influencer, thank goodness. So I would say, while the world feels upside down, when we look at credit markets and credit spread specifically, it kind of looks like everything is sunshine and rainbows. We always talk about spreads—and, just to remind people, spreads are the incremental yield you earn for lending to a company instead of a sovereign. So spreads, the way they finished last year, the way they've started this year, they're tighter, they're tighter in every major currency and they're tighter across investment-grade bonds, so higher-quality bonds, and they're tighter in high-yield markets, so lower-quality bonds. Just to remind people, as risk premiums or spreads compress, everything else being equal, bond prices rise. That's good for people who are invested in credit. Now, historically, for lending to higher-quality companies, you earned about 1.5% extra, today that's less than 1%, and for lower-quality companies, high yield, today you earn about an incremental 3%, and the historical average is about 5.5%. Overall compensation for lending, those risk premiums, are pretty skinny.

[00:02:46] Brian Carney: Anticipating your next question, Kevin, as I like to do, so you say, how can this be when things are so chaotic or seem so chaotic in the everyday world and credit markets seem so calm? Again, I want to

remind people that about two-thirds of the global credit market is denominated in U.S. dollars and about half of the issuers in the credit market are domiciled in the U.S. So all the things that are causing many of us angst—higher tariffs and other policies coming out of the new administration—coupled with lower taxes, reduced regulation, all of those things could and should be good for companies that are based in the U.S. and doing most of their business in the U.S. If you're inside the walls of the fort, it's all good, anything goes, full steam ahead. The challenge for that, as a lender, is we believe if companies are earning higher revenues, higher net income, generating more cash flow, if and when those things transpire, those are likely to accrue to the benefit of shareholders and not to lenders—so mergers and acquisitions, share buybacks, special dividends. I said it last time, I think, it's not going to be cool to deleverage in Donald Trump's America. So as a lender, we need to beware. What should we be doing? And this is a similar theme to how we finished out last year. What should we not be doing? Investors should not be reaching for yield in our opinion, either by going down the credit quality spectrum by buying high yield or extending out the yield curve into longer data credit. We don't think investors are being compensated for taking those risks. This is a market where investors should focus on protected capital. The theme from our last conversation has carried over into this conversation.

[00:04:22] Kevin Minas: So with spreads being as tight as you mentioned, is it safe to assume then that defaults are relatively low right now? You mentioned that the markets are pretty calm. Is that a safe assumption or are there weaker pockets of the market that you guys are looking out for?

[00:04:36] Brian Carney: Yes, are the short answers. The slightly longer answer is just to remind people what default risk is: That's the chance that a borrower fails to make interest or principal payments. Credit spreads are the compensation an investor receives for accepting default risk when lending to a company, and the lower the credit quality, the higher the default risk, so the more compensation you should get. Right now, our good friends at J.P. Morgan have pegged a long-term average default rate at about 3% for lower-quality bonds. So about 3% of the market should default every year. Today, as we look back at 2024, we're right on that 3% default rate. And of those companies that default, the recovery rate for lenders is about 35%, so you get about 35 cents on the dollar back, dollar lent, for every company that defaults. We're seeing some cracks in certain segments of the lending markets, and you've probably seen articles about credit card delinquencies going up, mortgage delinquencies seem to be creeping higher. That hasn't really translated into higher bond defaults yet.

[00:05:41] Brian Carney: I would also point out that although the long-term average is about 3%, we have had periods where default rates spike into double digits. So if you think 2009 global financial crisis, 2020 COVID, default rates spiked significantly, and at the same time that default rates spike, we tend to see lower recovery rates in those periods too. Markets can be kind of expensive and complacent for long periods, and then they get punctuated with periods that can be pretty awful for lenders. One of the reasons we believe default rates haven't gone up is we are seeing what I would call intensified competition within credit markets targeting lower-quality issuers. So there's the high-yield bond market, the private credit markets, which I know you've written extensively on, there's a resurgence in leveraged loan markets fueled by CLOs, and then the traditional banks are trying to muscle back into all that business that they've given away. You saw J.P. Morgan just the other day saying we're going to commit $50 billion to direct lending and they're a traditional bank—that is really what their business is, and they're recommitting capital to it. There's a lot of capital chasing relatively few transactions. What's the outcome of that? Companies that in a different time might have defaulted and been forced to either restructure or liquidate now have more options. So there's more lenders and some of those lenders, some of those markets, are willing to tolerate higher leverage, weaker business models, what we call PIK, so pay-in-kind structures, all of these things, which allow weaker borrowers to continue operating when in different times, different areas, they

might have actually been forced to default.

[00:07:20] Brian Carney: The last point I'd make: It's surprising to me we haven't seen spreads widen in other markets, other non-U.S. credit markets—Europe, Asia, Australia, those markets that are outside the walls of the fort—which could seriously be very much negatively impacted by what's going on within the U.S. So we're watching for signs of weakness in those markets, but we haven't seen any yet.

[00:07:44] Kevin Minas: Picking up on that comment around the banks making a pushback on the lending side. They had pulled back post-financial crisis. There were capital rules that were put in place that made it more costly for them to lend. So now that they're moving back in, you mentioned J.P. Morgan just as an example, but does it tend to be on balance sheet or are these private credit funds that they're raising?

[00:08:02] Brian Carney: I think it's a combination of both. You've actually seen banks become investors in private credit funds, and then you've seen banks also competing against those very same private credit funds to do loans that they would keep on their own balance sheet. As a bank, using J.P. Morgan as an example, and I don't want to speak for their strategy, but it seems like wherever those companies are borrowing, whether it's traditional bank, private credit, leverage loan, they want to be in that market and they want to be taking exposure. They want to be acting as underwriter, distributor, trader. They want a piece of the action, regardless of where that takes place, so you've seen a number of banks make announcements where they're going after a market that five years ago they had been willing to give up.

[00:08:48] Kevin Minas: Now, the global credit strategy is a very broad mandate. The focus is investment-grade credit, investment-grade bonds, and high yield. But the investable universe includes a lot of other categories as well—securitizations, potentially private debt, you mentioned leveraged loans, and actually you also mentioned CLOs, so collateralized loan obligations. Focusing on CLOs specifically, they aren't really an area I think we've talked much, if at all, on the podcast to date. Can you briefly walk us through what CLOs are, are they on the team's radars, the things you're looking at, and if you guys have a current view on the market and any interesting positioning, if you do have any.

[00:09:26] Brian Carney: Trying to simplify it, CLOs, they're a structured vehicle, so they raise money, a little bit of equity, a lot of it debt-financed, and they take that money that they've raised and they invest it in a portfolio of loans. They could be traditional bank syndicated loans, where there's a little more transparency, a little broader syndication, or more traditional private credit, which are narrowly distributed loans with less transparency. These are typically put together with a 10-year life cycle. There's a ramp-up period, a reinvestment period, et cetera, et cetera. Effectively, though, CLOs are the driving force behind the leveraged loan market. The leveraged loan market is about a trillion two in value U.S. dollars. About 65 or 70% of that market is owned by CLOs. It's just another way of creating demand. It's leverage on top of leverage. What we've seen in 2024, again, we talk about complacency. We talk about getting further and further away from the last crisis. Markets kind of find innovative ways to reach for yield, which is something we don't think people should do. Again, our friends at J.P. Morgan have some statistics. CLO issuance in 2024 exceeded 500 billion and that's versus a little over 160 billion in 2023, so a huge increase and new CLOs—not just existing CLOs—new CLOs put together were almost 250 billion, and that's 100 billion more than in 2023. We talk about demand for lower-quality product coming from a number of places. A lot of that demand has come from the rebirth of the CLO market in 2024. The leveraged loan market really exists and depends on the leverage embedded in CLOs, and I think the enthusiasm for CLO debt and the knock-on enthusiasm for leveraged loan demand is unmistakable based on the numbers I just gave to you. It’s just another example of that leverage on leverage in an opaque market and an example where investors are reaching for yield, relatively marginal pickups in yield. We think it's a market that we're watching very closely because if there's a dislocation, it will absolutely hit the leverage loan market as it hits the high-yield market.

[00:11:47] Brian Carney: If you look back to 2008, I think the high-yield index was down about 26, 27%. The leveraged loan index, which are meant to be very top end of the capital structure, the most senior portion of the capital structure for lower-quality companies, the leveraged loan market was down about 30%. So it behaves in a similar fashion to high yield. It's a market that's of interest, and it will be something that we likely will include in some small portion in the global credit strategy at some point, but today it's just another market we're monitoring, Kevin.

[00:12:22] Kevin Minas: And then maybe a follow-up to that, and also, I guess, tying together some of the points you made on some of the previous questions. Spreads are tight. You mentioned these areas of risk. Why not just a little bit of high yield or a little bit of pick your other segment of global credit? Certainly points well-taken in terms of the spreads being tight and the risks that are there. Aren't there some opportunities in some of these markets? Why the posture, I guess, of no allocations to some of these segments at this point in time? You could just sort of walk through your thinking there.

[00:12:49] Brian Carney: Stepped in and I know that's why you asked the question. And maybe you're trying to goad me into saying, oh yeah, OK, we'll put a little in. Howard Marks, one of the founders of Oaktree, writes a wonderful letter in the fall pointed out that the all-in yield on high yield was about 7%. That's kind of where we are today, 7%. I think his quote was, "Who doesn't love a 7% return?" When you think about that, you're like, OK, what could it hurt? I'm not going to have 100% high yield because if something goes wrong, I could really be in trouble, but if I just have a little bit, that adds a little bit to the portfolio, a little more yield, and that should be OK. So what could it hurt? I'll give you some numbers. In 2008, a portfolio of investment-grade bonds, so not high-yield bonds, produced a negative return of a little over 5%. So negative 5% in higher-quality bonds. If you had a portfolio of 75% investment grade and 25% high yield, that return all of a sudden becomes negative 11% plus. That's only 25% in the portfolio. Another way to think about it: If you started 2008 investors thinking, OK, maybe the market looks a little frothy, a little expensive, I want to preserve capital. That's one of the reasons I have fixed income. If they had short-dated investment-grade corporates in 2008, and that's all they had, it would have been a slightly positive return, less than 1%, but positive. At 25% high yield to that portfolio where you were generally conservative, but I want a little bit of a boost, all of a sudden that return is negative 7%-plus. Was that potential benefit of owning 25% of high yield at the start of 2008 worth it? I would say no because the incremental yield benefit in 2008 was about 1%. You're adding 25% high yield in the hopes that you're going to get an extra 1%. Today, when you do that same calculation, that potential incremental yield benefit of 25% high yield is about 60 basis points, 0.6 of 1%. We don't believe investors are compensated for the risks inherit in high yield. We didn't believe it in 2008. We certainly don't believe it today. So I appreciate the temptation is there. Just a little bit more, how risky can it be? We're in that type of market where people seem to be willing to make those concessions, but if the concession means you don't sleep as well at night, and if something goes wrong, your slightly positive return becomes decidedly negative, it's not worth it.

[00:15:21] Kevin Minas: So definitely a discipline on valuation, I guess is the key summary there. Then I suppose on the other end too, by protecting capital, now you're saving dry powder for, if you have that dislocation, you've got some pretty attractive opportunities that you've got capital you can put to work.

[00:15:35] Brian Carney: That's the punchline, which I failed to give. So thank you for giving it because that's right. The opportunity cost of being 25% already in high yield means you couldn't move into high yield at exactly the right time. Thank you for doing my job.

[00:15:51] Kevin Minas: No problem. We've covered high yield a lot, and we've covered a few things that we don't own in the portfolio. I want to shift a little bit and talk much more about what we do own in the portfolio, so if you could walk us through your current portfolio positioning, your current views on the market, and what the characteristics of the portfolio are today.

[00:16:08] Brian Carney: Just to remind people, the portfolio characteristics are the sum total of a series of individual credit determinations. If we're doing our job right, executing our process right, those individual determinations should insulate the portfolio from risk in expensive markets, which is what we believe we're in now, and then activate into attractive situation in dislocating markets. So again, we don't want to diversify away return potential, but we don't want to bet the farm either. We typically would think we'd have 20 to 30 names in the portfolio, 10% maximum weight. Today, we have 23 unique issuers in the portfolio. We're unsure where longer-term yields are going to go. As a consequence, we're buying shorter-dated bonds, so the duration of the portfolio is just a little longer than one year. For reasons we just talked about, we're staying away from lower-quality credits, and we've got a very, very high-quality strategy with no high yield. So, 81% of the portfolio has a credit rating of single A or better. In terms of geographic exposure, for those who are interested, about three-quarters of the portfolio are companies that are domiciled in the U.S., about 14% Canadian and about 8% European. Then the last point I would make just to remind people because it's really important: When we buy non-Canadian securities—and most of the portfolio is invested in U.S. dollar-denominated securities—we're hedging back that currency risk using three-month currency forward. So, we're isolating credit risk, and we're not taking currency risk.

[00:17:44] Kevin Minas: I do have one more topic that I'd like to cover, but before we do that, is there any other items of interest, things you'd like to cover before we move to that final topic?

[00:17:52] Brian Carney: There's a few things sticking in our mind as we look at markets these days, and the first is we're thinking a lot about the U.S. government, less about the daily noise that's coming out of the Oval Office, but more about two-thirds of the credit markets are denominated in U.S. dollars, and the U.S. Treasury yield curve is the benchmark off which corporations are borrowing money. With all the unpredictable policy announcements, the uncertainty over whether the deficit is going to grow by X or Y, regardless of whether Mr. Musk is successful, what's the impact of further tax cuts on the deficit? Forget the policy quality. The credit quality of the U.S. government is a growing topic of conversation. To me, it seems that a downgrade by Moody's, who are the last agency to have them rated AAA, is a question of when, not if. And so right now we've got U.S. ten-year yields at about 4.3%. Those look really attractive because a few years ago they were 1%. If the credit quality of the U.S. government is now being called into question, which I think it is and should be, we are in a position where we're now forced to evaluate not just the credit quality of the issuers we're looking at. We have to think about the credit quality of the benchmark that we're pricing those issuers off of. That's something, quite frankly, you kind of have to go back to Canada in the 1990s when deficits were kind of out of control here, in my mind, to come up with a similar situation. Credit quality of the U.S. government, top of mind.

[00:19:22] Brian Carney: I came across something, we talk a lot about private credit, you and I, Kevin, again, I know you've written on it. It's one of my favorite topics. There was a great article in Bloomberg about a week ago,

and the title of the article was “Wall Street's New Money Is Shaking Up the Ranks of the Superwealthy,” and it highlighted how many billionaires have been minted. According to them, it was 18 by the private credit industry, which raised a question for me, and the question is—and you don't have to answer on this call—you can just take it away and think about it. The question is: Is it better to be a private credit manager than a private credit investor? Because I haven't seen many articles written about how many private credit investors have become billionaires. Let's just say that's a rhetorical question. It's interesting as we think about how much money has gone into private credit, it does raise a question about what are the fee structures versus the benefits of that, et cetera, et cetera. I thought that was interesting.

[00:20:21] Brian Carney: Then finally, just a thought on the companies that we are thinking about including in the strategy or have included in the strategy, high-quality companies, we think should be setting policy for more than just kind of a one- or two-year horizon. And management teams, if they're really doing their job, should be able to plan and should expect to outlast any one administration or regulatory regime. We're being vigilant, and I'm sure our colleagues on the equity side are as well for companies that are dramatically changing their business models or financial policies based on what may prove to be short-term extreme changes in government policy. So a number of things we're thinking about and monitoring, and in the case of private credit, having a chuckle about.

[00:21:04] Kevin Minas: Three interesting thoughts, no doubt. In the interest of time, I'm going to move to the last topic. Maybe we could circle back on some of those thoughts on a future podcast. As of the end of January, the global credit strategy hit its one-year anniversary. Congrats to you and the team. Just want your thoughts on how the year went and plans for the future for the strategy.

[00:21:23] Brian Carney: Thanks for noting that, I've got to say, we are ecstatic with the progress Mawer’s made on GCO global credit in 2024. I think you'll know, as a credit person, I don't use the word ecstatic. It's a superlative. I don't use those very often to describe anything. Everything from putting the investment process in place to an on-time launch, to the take-up by investors that we've spoken to, to the interest by individuals and institutions and hearing the story and understanding the strategy, I would say everything to date has exceeded our expectations and we had really high expectations. AUM in the strategy is about 150 million. That's well ahead of where we thought we'd be. Plans for the future with your help, Kevin, and many others, our goal is to continue to spread the good word. We believe GCO can function as either the entirety of an investor's fixed-income solution or a portion of it, depending on the investor's risk tolerances and other things, and we expect to see AUM growth in three areas, continued take up by individual clients. There is a move afoot for inclusion in balanced funds for the strategy that's in the works that'll take several months, but we're excited about that. We're laying a lot of groundwork with institutional clients who demand and expect a longer track record for the strategy—three to five years in many cases—but we're laying that groundwork now for future mandates. We're excited about that. Just kind of day-to-day, a key tenet at Mawer, as you know, is not to sit still, keep learning, keep fine-tuning, so we'll continue to work on the process, our risk-scoring framework, collaboration with our equity colleagues, using technology smarter to help refine what it is we're looking at and examining. We're going to add selectively to the team. We're excited about that. All to the end that we believe we're building something really unique and special in terms of a credit business here at Mawer, and Mawer itself is a really unique and special place. So our objective is to build the world's best credit manager within the world's best investment management firm. So super excited about 2024 and extremely excited about the prospects for 2025 and beyond.

[00:23:39] Kevin Minas: Awesome. Yes, definitely exciting, and thanks again for joining as always, Brian. Appreciate your time.

[00:23:43] Brian Carney: Thanks, Kevin. Good to talk to you.

[00:23:45] Kevin Minas: Hey everyone, Kevin here again. To subscribe to the Art of Boring podcast, go to mawer.com. That's M A W E R dot com forward slash podcast, or wherever you download your podcasts. If you enjoyed this episode, be sure to leave a review on iTunes, which helps more people discover the "be boring, make money" philosophy. Thanks for listening.